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2015/16

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International transfer pricing 2015/16

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Preface

Isabel Verlinden

It is my pleasure to present the 2015/16 edition of our *International Transfer Pricing* book. There have continued to be significant changes in the area of transfer pricing since our prior edition, with several new countries implementing either formal or informal transfer pricing documentation requirements and significant regulatory changes in many other countries over the past twelve months. Most significantly, the deliverables released as part of the OECD's Base Erosion & Profit Shifting (BEPS) Action Plan have resulted in the need for enterprises to reevaluate and reconsider their transfer pricing strategies in light of the proposed new guidance.

Part 1 of the book provides a general overview of the global approach to transfer pricing issues. **Part 2** is devoted to a summary survey of specific requirements of the key countries with transfer pricing rules.

We anticipate that this will be another eventful year during which the subject of transfer pricing will continue to be at the centre of continuing controversy in corridors of power and newspaper editor's offices around the world. A combination of public debates on the ethics of tax planning, political and economic pressures, and increasingly well trained tax examiners will all contribute to a continuing rise in the number of transfer pricing disputes globally especially as a growing number of tax authorities attempt to enforce their transfer pricing rules more aggressively. It is PwC's[1] view that strategic dispute management (such as through dispute avoidance or alternative resolution techniques) on a global basis will become increasingly crucial in companies' efforts to sustain their global transfer pricing strategies and to maximise efficiencies enabled by a constructive atmosphere with tax authorities.

We look forward to working with you in 2015 and beyond.

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Preface

Nick Raby

This book provides you with general guidance on a range of transfer pricing issues. Technical material is updated with each new edition and this book is correct as of 30 April 2015. This 2015 edition is the latest development of a work begun over two decades ago and is now in its 15th iteration.

In addition to this reference book, many of you will also require real-time access to current information. Readers wishing to receive e-newsalerts on current transfer pricing can register for our *Tax Insights from Transfer Pricing*. Given the number of disputes and controversy issues involving transfer pricing matters readers may also be interested in a separate PwC service *Tax Insights from Tax Controversy and Dispute Resolution*.

The challenges facing multinational enterprises in preparing documentation to demonstrate compliance with transfer pricing rules across the globe in accordance with the expectations of each jurisdiction continues to grow. Most countries/territories have now established documentation rules that require companies to state clearly and with supporting evidence why their transfer pricing policies comply with the arm's-length standard.

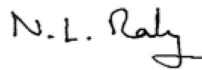
A large number of jurisdictions have also implemented strict penalty regimes to encourage taxpayers' compliance with these new procedures. Perhaps the biggest practical difficulty facing taxpayers in their efforts to abide by these requirements, are the subtle differences in transfer pricing documentation expected across the various tax jurisdictions. These conflicting pressures need to be reviewed and managed very carefully, both to meet the burden of compliance and to avoid costly penalties.

Many of the world's major tax jurisdictions have established aggressive audit teams to review compliance with these documentation requirements and are exhibiting a new found willingness to pursue transfer pricing adjustments through administrative appeals procedures and even to litigation. Non-compliance now comes with a significant risk of being assessed with material adjustments and penalties. For many years, companies accepted nominal adjustments as a small price to be paid to get rid of the tax auditor. In the current environment, however, adjustments have now become potentially so material that companies cannot simply write off assessed adjustments without recourse.

These developments are reflected in the increasing use of mutual agreement procedures under bilateral double taxation agreements, or the Arbitration Convention within the European Union, in order to seek relief from double taxation and unsustainable proposed adjustments. This, in turn, necessitates a more controlled and organised approach by companies to handle the audits as they take place, to ensure the process is conducted efficiently and that any areas where the transfer pricing system is deficient are corrected rapidly.

If these challenges were not enough, the subject of transfer pricing has become the centre of a new public controversy on the issue of whether the current rules permit multinational entities to pay less than their 'fair share' of the overall tax burden in some of the territories in which they operate. In addition to compliance with a very technical and complex set of statutes, case law, regulations and guidelines, taxpayers may now need to evaluate the potential impact of decisions related to transfer pricing in more subjective areas such as corporate reputation and public perceptionIn this book, my fellow authors and I demonstrate that transfer pricing is a matter that is of fundamental importance to multinational enterprises. It is vital for every company to have a coherent and defensible transfer pricing policy, which is responsive to the very real climate of change in which companies are operating. A sound transfer pricing policy must be developed within a reasonable timescale and be invested in by both company management and professional advisers. It needs to be re-examined regularly to allow for changes in the business, perhaps as the result of acquisitions or divestments of part of the group. Today, a properly coordinated defence strategy is a basic necessity rather than an expensive luxury.

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



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**Nick Raby is the principal in charge of transfer pricing services for PwC in the Western Region of the United States, and has extensive experience in advising on transfer pricing and tax planning for multinational companies. His international experience includes six years in London, and three in Brussels and Amsterdam.*

The author would like to thank the many transfer pricing specialists from the PwC international network who have contributed to this book. Special thanks also go to the editorial team, Liz Sweigart and Dana Hart.

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Glossary

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

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

OECD's Base Erosion and Profit Shifting (BEPS) Action Plan: A programme introduced by the OECD in July 2013, that established 15 actions related to harmonising and coordinating international tax and transfer pricing rules across jurisdictions.

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

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

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

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

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

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

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

GATT: General Agreement on Trade and Tariffs.

Inland Revenue: The UK tax authority.

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

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

OECD: The Organisation for Economic Cooperation and Development.

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

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

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

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

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

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

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

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

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

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

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

Part 1: Developing defensible transfer pricing policies

1.
Introduction

At the eye of the 'perfect storm'

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

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

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

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

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

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

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

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

The importance of keeping policies and procedures up to date

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

transactions undertaken by the company, as well as produce arm's-length results and prevent unwelcome surprises.

Theory and practice

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

Transfer pricing is not just about taxation

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

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

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

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

New legislation and regulations

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

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

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

At the time of publication, a further series of revisions to the OECD Guidelines are in progress under the OECD's Base Erosion and Profit Shifting (BEPS) initiative. *(Chapter 11 provides further details)*.

The future

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

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

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

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

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

Introduction

2.

Categories of inter-company transfer

Introduction

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

The arm's-length principle

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

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

Sales of tangible property – definition

Tangible property refers to all the physical assets of a business. Sales of raw materials, work in progress and finished goods represent a major portion of the transfers that take place between related parties, typically referred to as sales of inventory (*see Sales of inventory, below*). However, it is important to bear in mind that 'sales of tangible property' can include all the machinery and equipment employed by businesses in their day-to-day activities as well as the goods they produce.

Categories of inter-company transfer

Sales of machinery and equipment

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

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

Sales of inventory

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

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

Example

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

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

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

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

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

Transfers of intangible property – definition

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

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

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

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

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

relates is sold in very competitive markets) is sometimes referred to as an 'ordinary' or 'routine' intangible.

Types of intangibles

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

Categories of inter-company transfer

Modes of transfer of intangibles
Intangibles can be transferred between related entities in four ways:

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

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

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

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

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

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

Example
Consolidated Wafers Ltd. (CWL) designs and manufactures semiconductors. Its research and development (R&D) department has designed a memory chip that is significantly faster and uses less power than any other chip on the market. CWL has an

absolute monopoly on the production of this chip until a competitor 'reverse engineers' the chip and markets a clone. At that time, CWL's ability to remain successful in the market will be determined by its ability to produce high-quality chips at lower cost (higher yield) than its competitors. Typically, in the semiconductor industry, this process may take less than two years.

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

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

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

Marketing intangibles

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

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

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

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

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

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

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

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

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

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

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

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

The provision of services – definition

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

Examples of types of service

Five types of service may be provided to related parties:

1. The service can be a routine service, such as accounting or legal services, where no intangible is transferred. In situations such as this, the price charged in arm's-length relationships is invariably based on a cost-plus formula where the 'plus' element varies greatly with the value added of the service and the extent of competition within the market. In the inter-company context, many countries allow reimbursement on a cost-plus basis, though with a relatively small and steady uplift for services that are regarded as being low risk and routine. However, a minority do not allow the inclusion of a profit or have restrictive rules.
2. The service can be technical assistance in connection with the transfer of an intangible, either manufacturing or marketing, but usually a manufacturing intangible. Typically, in arm's-length relationships, a certain amount of technical assistance is provided in connection with a licence agreement (at no extra charge). If services in excess of this level are needed, arm's-length agreements usually allow for this at an extra charge, typically a per diem amount (itself determined on a cost-plus basis) plus out-of-pocket expenses.
3. The service can be technical in nature (pertaining to manufacturing, quality control or technical marketing), but not offered in connection with an inter-company transfer of the related intangibles. In this situation, only the services provided are paid for on an arm's-length basis.
4. When key employees are sent from their home base to manage a new facility, some tax authorities have tried to assert that there is a transfer of intangibles. For example, when a new manufacturing plant is established outside the home country, it is not unusual for a parent company to place a key manufacturing

employee in that plant as plant manager to get it established and to train a local employee to take his/her place. Such a relationship may exist for three to five years.

The tax authority may take the position that the knowledge and experience in the head of that employee is an intangible, owned by the parent company, which should therefore be compensated by the subsidiary for the use of the intangible asset. However, in arm's-length relationships between unrelated parties, such a new manufacturing plant could easily recruit a plant manager from existing companies in the industry. In such a case, the plant manager would be paid a market-determined wage and no royalty would be payable to any party. Therefore, it would appear that no royalty is appropriate in the context of the multinational group, although a service charge might be needed to cover the cost of the assignee.

5. A combination of (1) to (4) above could exist where the offshore affiliate requires the expertise of the parent in order to manage its own affairs, including determining its strategy. In this situation, the substance of the relationship is that the parent company is managing the offshore affiliate with little or no local input. The substance of the relationship is such that the parent company tax authority can easily show that the amount of profit allowed to the offshore affiliate should be minimal in that it is performing a service for the parent (e.g. through a contract manufacturer arrangement or a manufacturer's representative arrangement).

The problem of 'shareholder' services

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

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

Duplicate services are those that are initially performed by a company and duplicated by an affiliated entity, often the parent company. An example would be a marketing survey of the local market, which is completed by the subsidiary but redone by the

parent (because it did not trust the subsidiary's work, for example). In cases of this type, the parent cannot bill its costs to the subsidiary for this service. However, if it can be shown that the subsidiary requested the service to ensure that its marketing survey was correct (i.e. that the parent's input added value to the subsidiary), the position would be different.

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

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

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

Table 2.1 Costs often incurred by a parent company

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

Example

Beautiful Unique Bathtubs SA (Bubble) is a French company that manufactures bathtubs in France for resale to related companies throughout Europe. Bubble developed the manufacturing intangibles associated with the production of the

bathtubs and completes the entire manufacturing process in its plants in France and Sweden. The technology involved is unique in that the bathtub produces its own bubbles when the surface is wet. This process has been licensed to an unrelated Canadian company in exchange for a royalty of 5% of sales. Ten workdays of technical assistance are provided to the Canadian company free of charge.

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

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

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

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

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

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

Financing transactions

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

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

- The rate of interest on the loan (including whether it is fixed or floating).
- The capital amount of the loan.
- The currency.

- The credit worthiness of this borrower (including whether any guarantees have been provided in connection with the loan).

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

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

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

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

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

Financing short-term capital needs

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

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

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

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

Example
TLC Inc. (TLC) is an American company that has recently established a new subsidiary in the UK (TLUK). TLC manufactures a special line of pillows that lull small children to sleep within 10 minutes of lying down. The pillows are successful in the US market but have just been introduced in the UK market and are not currently selling very well. The parent company sells the pillows to TLUK, which is responsible for marketing and distribution. The overhead expenses of the subsidiary are greater than the current sales revenue, and serious cash-flow problems exist in the UK. These problems can be addressed as follows:

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

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

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

Market penetration payments
An alternative to the financing schemes discussed in *Financing transactions and Financing short-term capital needs sections, earlier*, is to use a market penetration or market maintenance mechanism. In this situation, the manufacturing company treats the related selling company’s market as its own in the sense that the manufacturer wishes to expand its sales into a new market. Because its products have not previously been sold in the new market, it must penetrate the market through marketing (e.g. advertising or through a reduction in price to customers – below the price that is

expected to be charged after achieving the desired level of sales). These costs are the costs of the manufacturer rather than the distributor.

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

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

Cost-sharing

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

Financing long-term capital needs

Long-term capital needs can be financed through:

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

Mortgages

The purchase of land can be accomplished through a lump-sum payment or through a mortgage. Use of a mortgage means that the total cash outlay for the land is spread over a period of years. Usually, the interest rate on mortgages is lower than for

unsecured loans (whether short- or long-term), so that it is cheaper to raise funds through this mechanism than through other types of debt financing.

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

Lease financing

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

Capital stock

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

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

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

Long-term inter-company loans

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

At the subsidiary level, tax deductions are normally available for interest expense. However, thin capitalisation is increasingly an area that is scrutinised by tax

authorities, so particular attention must be given to the gearing levels acceptable in the borrowing country. Careful attention must also be given to any double taxation agreement in force between the countries involved.

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

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

Categories of inter-company transfer

3.

The work of the OECD

Introduction

The Formation of the OECD

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

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

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

The OECD report and Guidelines on transfer pricing

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

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

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

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

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

On 22 July 2010 the OECD published revised Chapters I – III of the OECD Guidelines covering the arm's-length principle, transfer pricing methods and comparability analysis. At the same time, final guidance on the Transfer Pricing Aspects of Business

Restructurings was issued, which is now incorporated into the OECD Guidelines as a new Chapter IX.

To summarise the main points, the 2010 OECD Guidelines:

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

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

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

New OECD initiatives

Reflecting a much higher level of activity by the OECD, a number of new initiatives have resulted in pronouncements that potentially have significant impact on transfer pricing matters. In December 2006 final versions of Parts I, II and III of the *Report on Attribution of Profits to Permanent Establishments* (PE Report) dealing with general considerations in relation to the taxation of permanent establishments and application of these principles to banks and in the context of global trading were issued. This was followed on 22 August 2007 by a revised Part IV dealing with insurance. A final version of the combined parts to the PE Report was finally issued on 17 July 2008. The 2008 PE

Report then spawned a project to update Article 7 and the Commentary to that Article, resulting in the revised text of the old Article 7 and associated commentary, as well as a new Article 7 included in the 2010 update to the OECD Model Tax Convention. Also in 2010, an amended and updated version (but not fundamentally altered from 2008) of the PE Report was issued in order to reflect any necessary minor amendments to make the report consistent with the new Article 7.

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

The arm's-length principle

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

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

Guidance for applying the arm's-length principle

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

- The specific characteristics of the property or services.
- The functions that each enterprise performs, including the assets used and, mostimportantly, the risks undertaken.
- The contractual terms.

- The economic circumstances of different markets, for example, differences in geographic markets, or differences in the level of the market, such as wholesale vs. retail.
- Business strategies, for example, market penetration schemes when a price is temporarily lowered.

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

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

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

Transfer pricing methods

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

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

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

Comparable uncontrolled price method

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

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

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

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

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

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

Example

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

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

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

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

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

Resale price method

An arm's-length price is determined using the resale price method by deducting an appropriate discount for the activities of the reseller from the actual resale price. The appropriate discount is the gross margin, expressed as a percentage of net sales, earned by a reseller on the sale of property that is both purchased and resold in an uncontrolled transaction in the relevant market. Whenever possible, the discount should be derived from unrelated party purchases and sales for the reseller involved in the inter-company transaction. When no such transaction exists, an appropriate discount may be derived from sales by other resellers in the same or a similar market.

The OECD Guidelines recognise that there are problems in obtaining comparable data, for example, where there is a considerable period of time between the comparable transaction and the one under review within the group, where movements within the economy (i.e. foreign exchange rate, interest rate, recession or boom) generally would cause possible distortion.

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

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

Cost plus method

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

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

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

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

Example

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

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

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

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

Cost plus method – capacity adjustments

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

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

Example

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

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

Profit split method

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

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

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

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

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

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

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

Example

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

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

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

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

Transactional net margin method

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

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

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

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

Return on assets

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

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

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

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

Example

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

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

Berry ratio compared to return on sales (ROS)

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

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

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

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

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

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

Example

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

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

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

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

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

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

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

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

OECD commentary on other matters impacting transfer pricing

Safe harbours

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

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

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

Advance pricing agreements (APA)

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

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

Documentation

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

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

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

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

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

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

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

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

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

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

Member countries of the OECD

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

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

Recent developments at the OECD

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

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

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

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

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

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

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

Transfer pricing aspects of business restructurings

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

are used by one or both parties to the controlled transaction in connection sales of goods or services but there is no transfer or intangibles. The second type of transaction involves situations in which the rights to intangibles are transferred as part of the controlled transaction. Attention is also drawn to 'combinations of intangibles', the (artificial segmentation) thereof and the link with the choice of transfer pricing methodology and tested party. In certain situations, bundled transactions are sufficiently unique that it may not be possible to identify comparable transactions.

In some cases, it may be necessary to 'segregate the various parts of the package of services and intangibles for separate transfer pricing consideration'. In other cases, one or more intangibles and/or services are 'so closely intertwined that it is difficult to separate the transactions for purposes of a transfer pricing analysis'. Nuances have been highlighted through the use of examples in the consumer products, pharmaceutical and information technology industries.

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

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

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

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

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

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

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

The OECD and the new United Nations transfer pricing manual

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

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

4.

Establishing a transfer pricing policy – practical considerations

Arm's-length pricing – market prices

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

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

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

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

Obviously, if the facts change, the characterisation of the entities involved in the inter-company transactions will change accordingly and the prices used in the inter-company transactions must be adjusted. Consequently, the first step in establishing a transfer pricing policy must be to gather all the relevant facts and circumstances surrounding a particular inter-company transaction. These facts can be summarised in three categories: functions (*see Functions, below*), risks (*see Risks, below*), and intangible and tangible assets (*see Intangibles, below*).

Establishing a transfer pricing policy – practical considerations

Functional analysis

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

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

Interviews

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

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

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

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

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

- Manufacturing functions: production scheduling, production process, materials purchasing, supplier approval, personnel education and training, quality control procedures, quality control implementation, reporting relationships, process technology and improvement.

- Marketing functions: strategic marketing plans, advertising, trade shows, sales force, the relative autonomy of various entities in marketing the company's products, forecasts, selling techniques, key marketing personnel, new market penetration, reporting relationships, and training.
- Distribution functions: warehousing and distribution, inventory, warranty administration, third-party distributor relationships.
- Administrative, management or other inter-company services performed on behalf of other related parties and/or third parties.

Other information or documents required

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

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

Functions

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

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

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

price and quality of the finished goods, the reliability of supply and other areas of the business process.

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

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

Table 4.1 Typical business functions

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

Risks

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

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

Table 4.2 Typical business risks
Market risk
Inventory risks: raw materials, work in progress and finished goods
Defective products and warranty
Credit risk
Product liability risk
Foreign exchange risk
Environmental risk

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

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

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

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

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

Establishing a transfer pricing policy – practical considerations

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

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

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

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

Intangibles

Table 4.3 provides a list of typical intangible assets.

Table 4.3 Typical intangible assets

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

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

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

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

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

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

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

Characterisation of businesses

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

Contract manufacturers and fully fledged manufacturers

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

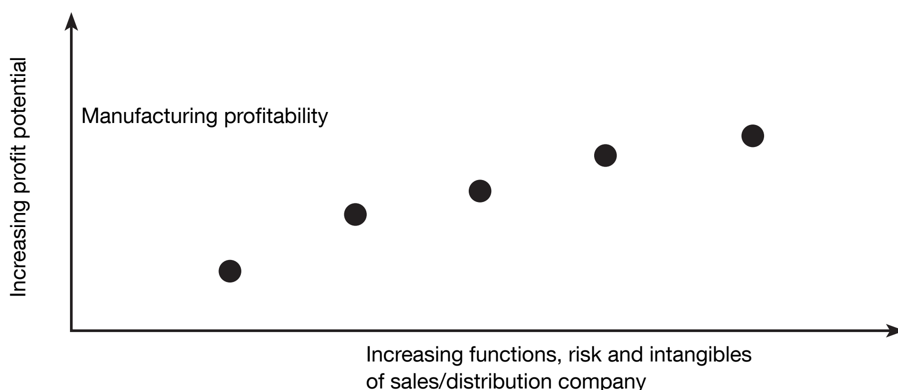
Contract manufacturers provide manufacturing services to fully fledged manufacturers. They do not develop their own product lines but offer expertise in performing certain manufacturing functions only. They may or may not perform such functions as materials purchasing and production scheduling or own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

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

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

Table 4.4 Characterisation of manufacturing entities

Contract manufacturer	Fully fledged manufacturer
Does not own technology	Owns technology
Little risk	Full of risk
	Purchasing
Little discretion in production scheduling	Production scheduling
Does not totally control equipment Scheduling	Select own equipment scheduling
Quality control usually dictated	Direct control over quality by customer
Usually manufacturing high-volume, mature products	Manufacturing products at all high-volume, mature products stages of product life cycle



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

Characterisation of distribution/selling companies

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

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

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

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

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

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

Establishing a transfer pricing policy – practical considerations

Goals of the multinational corporation

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

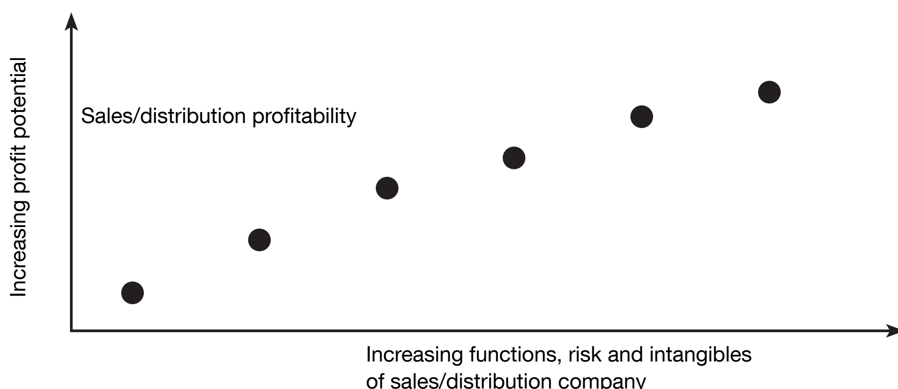
Financial goals include managing cash flows, supporting R&D, funding capital expansion, paying interest on debt, meeting tax liabilities in accordance with overall group tax strategies and funding dividend payments to shareholders. Satisfying each requires placing income in the legal entity where the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

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

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

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

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



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

Manufacturing opportunities

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

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

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

Centralised support activities

Many multinationals, responding to the globalisation of business, have centralised certain support services in an attempt to minimise costs. In various situations, support activities can be placed in low-tax jurisdictions to reduce the total income subject to tax in higher tax jurisdictions. For example, trading companies can be used to centralise

foreign-exchange risk and/or worldwide inventory control. Trading companies can be placed in any country where the requisite substance can be established.

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

Selling companies

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

Contract service providers

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

Contract research and development

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

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

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

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

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

Other reasons for establishing contract research and development

Contract R&D is a useful technique to employ when a subsidiary has special expertise available to it, which the parent wishes to exploit but where the subsidiary does not have funds available to cover the costs. By setting up a contract R&D arrangement, the parent company can finance the R&D activity that is conducted by the subsidiary.

Similar to a contract marketing service provider, an important consideration is that this arrangement is established before any R&D intangible is generated to ensure that the contract service provider is economically limited to the remuneration that it receives for performing such contract services. In other words, there is no pre-existing R&D intangible that it may have created before entering into a contract service.

Example
Semi-Chips Inc. (a US company) has been manufacturing and selling custom-designed semiconductor equipment for semiconductor original equipment manufacturers (OEMs) in the US for ten years. It recognises that a vast majority of semiconductor

OEMs (its direct customers) have moved operations to Asia. As such, the company has determined to establish a subsidiary in Taiwan to be closer to its customers. At the same time, the company has noticed that because of the large amount of semiconductor manufacturing activities in Asia, there exists a great deal of technical expertise in Taiwan. Due to this fact, the company determines that it is more efficient for the Taiwanese subsidiary to also conduct R&D activities for products on its behalf.

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

Contract maintenance

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

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

Contract marketing

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

Example

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

All activities would be approved and supervised by the management of the parent company. The service providers would be compensated on a cost-plus basis for their sales support and marketing activities. As a result, the parent company would arguably retain the economic ownership of the marketing intangibles in the local markets.

The evaluation of pricing options

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

The search for comparables

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

Example

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

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

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

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

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

Establishing a transfer pricing policy – practical considerations

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

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

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

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

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

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

When these obstacles to using the resale price method cannot be overcome, as is often the case, the transactional net margin method (TNMM) under the OECD Guidelines or the comparable profits method (CPM) in the US transfer pricing regulations, discussed in Chapter 3, would most likely be applied. When using the CPM/TNMM, the degree of functional comparability between the tested party and the uncontrolled distributors is less than that required under the resale price method to obtain a reliable result.

To search for comparables under the CPM/TNMM, a search for external comparable independent distributors with broadly similar functions as the tested party (i.e. Fishy US) using information obtained from the functional analysis, is conducted. Once this set of comparable companies is established, the profitability results of the distribution business of Fishy US are benchmarked against the profitability results of the uncontrolled distributors. If Fishy US profitability results fall within the range

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

Identifying appropriate comparables

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

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

Internal comparables

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

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

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

Example

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

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

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

Identification of internal comparables may be made through:

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

External comparables

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

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

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

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

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

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

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

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

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

Functional analysis and comparable information – an overview

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

Example

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

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

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

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

Documentation

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

How to document a policy

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

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

A description of the transfer pricing methodology used to test the arm's-length nature of the inter-company transactions.

- Guidelines interpreting the choice of the methodology.
- Inter-company legal agreements.
- Functional analysis of the entities involved.
- Comparables supporting the policy.
- Financial analyses of the comparables as well as the tested party.
- Industry evidence required to substantiate the decisions made.

Financial analyses

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

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

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

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

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

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

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

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

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

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

Evaluation of financial analyses

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

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

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

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

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

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

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

Transfer pricing policy

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

Transfer pricing guidelines

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

Inter-company agreements

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

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

Documentation of the functional analysis

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

Documenting the comparables

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

Income statements

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

Industry evidence

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

Implementing a transfer pricing policy

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

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

Monitoring the application of the policy

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

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

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

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

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

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

Compensation of management

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

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

5.

Specific issues in transfer pricing

Management services

Management fees – introduction

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

The importance of management fees

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

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

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

Specific issues in transfer pricing

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

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

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

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

Dealing with shareholder costs
Central services include services provided to:

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

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

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

Analysing the services

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

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

Example

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

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

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

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

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

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

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

The cost base for service charges

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

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

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

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

The cost-accounting method

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

The computation on a full-cost basis

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- A written description of the different services provided, summarising the type (specialist skills, seniority, etc.) and number of employees involved, any reports or other end products of the services, and a statement of the aims of the services (to save costs, increase sales, etc.).
- A full analysis of the cost base, including explanations of allocation formulae, how they apply and why they are appropriate; a detailed list of the expenses to be allocated (salaries, overhead expenses, etc.); and invoices from other entities where they substantiate expenses suffered.
- A detailed computation of the amount of each invoice submitted to the recipient entities – it should be possible for a computer to produce this calculation relatively easily once the cost base and allocation formulae have been established.
- A justification of the markup applied referring to comparables or market practice.

  In a Canadian case, the court gave detailed consideration to the subject of documentation of management fees and concluded that the following items of evidence would be of key significance:
  - Evidence of bargaining between the parties in respect of the amount to refute any inference that the taxpayer 'passively acquiesced' to the charge.
  - Working papers supporting the expenses charged.
  - Details explaining how the charges were calculated, including support for the apportionment of employee work performed or other expenses such as allocations of rental costs.
  - A written agreement for the management charge.
  - Evidence that the expenses relate to the period of charge rather than a prior period.

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

Contract services and shared service centres

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

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

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

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

Transfer of intangible property

Transfer of intangibles – introduction

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

Sale for consideration

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

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

Licence

The typical method of transferring intangible rights between related parties is through the use of an exclusive or a non-exclusive licence agreement. When a licence is used, the developer continues to own the property and can dispose of it as she/he see fit.

The rights given to the licensee may vary. In general, the licence is evidenced by a document specifying the terms of the licence. The key terms of a licence are likely to include the following:

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

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

Determination of arm's-length royalty rates

Determining the proper compensation due to the developer/owner of intangible property can be difficult. In setting an arm's-length royalty rate it is important to distinguish, as precisely as possible, what property is to be licensed. Once the property is identified, the rights granted to the licensee and their relative value is determined. The property may be an ordinary intangible in that it provides some, though not complete, protection from competitors (this type of intangible is sometimes referred to as a typical or a routine intangible). Alternatively, it may constitute a super-intangible, which effectively gives the licensee a monopoly or near-monopoly over the market in question. However, there is no difference in the approach to setting an arm's-length royalty. The concept of super-intangibles is mentioned here for completeness only.

It arose following the 1986 Tax Reform Act in the US. One of the key issues included was a requirement that the licence income to be enjoyed by a licensor in the US from an overseas affiliate should be 'commensurate with the income' associated with the intangible. There was concern that insufficient royalty income was being derived from US intangibles that proved to be valuable after being licensed overseas. There was considerable concern outside the US that excessive use has to be made of hindsight in this area.

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

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

The Irish subsidiary will manufacture the product for resale throughout Europe. ACAG wishes to maximise the income that it places in Ireland. Therefore, it is taking all steps necessary to ensure that the Irish subsidiary is a full-fledged manufacturer.

To this end, it has decided to licence the patent and related technical know-how to the Irish subsidiary.

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

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

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

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

Example
Assume that the ZapAway agreement (*see Determination of arm's-length royalty, above*) does not exist (i.e. ACAG does not licence the property to any third party). However, another competitor licences a similar product (another grass stain remover) to a third party. This licence agreement is subjected to the same analysis discussed above in

the *Determination of arm's-length royalty section*. If the differences do not affect the royalty rate or can be valued, then this third-party licence arrangement can be used as a basis for the determination of the arm's-length royalty between ACAG and its Irish subsidiary.

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

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

Super-intangibles

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

Valuation of royalty rates for super-intangibles

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

Example

Clipco Inc. (CI), a US company, is a manufacturer of shaving equipment. It has recently developed a new razor that is guaranteed never to cut, nick or scrape the skin of its

users. Its success is tied to a microprocessor, contained in the blade, which signals the blade to cut or not cut, depending on whether the substance it senses is hair or skin. Clipco has been granted a patent on this device and is currently marketing the razor in the US where it has obtained a 90% market share.

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

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

Table 5.1 Functional analysis

US PARENT		
Functions	**Risks**	**Intangibles**
Research and development	Foreign exchange (on royalty)	Patent
Marketing (on royalty)	Trademark	Unpatented know-how
Technical assistance		
IRISH SUBSIDIARY		
Functions	**Risks**	**Intangibles**
Manufacturing	Warranty	None
	Obsolete products	

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

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

Cost-sharing

In 1979, the OECD published a paper on transfer pricing and multinational enterprises. This document included a discussion of the experience of multinational enterprises in establishing and operating cost-contribution arrangements for R&D expenditure. The OECD summarised its knowledge of these arrangements and the experiences multinational companies have undergone in handling cost-sharing arrangements (which are referred to as cost-contribution arrangements (CCAs)) with tax authorities around the world. The OECD commentary has been widely regarded as best practice by many tax authorities and the comments in that paper, to a large extent, remain valid today. However, there are differences beginning to develop in practice, particularly in the US, as tax authorities obtain more experience of the operation of cost-sharing arrangements and become more sophisticated in dealing with multinational

corporations. For its part, the OECD issued Chapter VIII of its Transfer Pricing Guidelines, which governs the tax treatment and other transfer pricing issues related to CCAs entered into by controlled taxpayers. The guidelines set out in Chapter VIII are essentially the same as draft guidelines the OECD originally proposed in 1994. The primary principle surrounding the OECD's determination of whether a cost allocation under a CCA is consistent with the arm's-length principle is whether the allocation of costs among the CCA participants is consistent with the parties' proportionate share of the overall expected benefits to be received under the CCA.

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

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

Advantages of cost-sharing

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

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

Cost-sharing arrangements

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

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

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

Cost-sharing agreements

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

Allocation of costs among participants

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

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

Although most tax authorities prefer to follow the general tests previously propounded by the OECD and now embodied in Chapter VIII of the OECD Guidelines, some tax authorities have special rules for dealing with cost-sharing arrangements. The National People’s Congress of China recently passed the Corporate Income Tax (CIT) Law which will become effective 1 January 2008, and under Article 41 includes legal framework supporting CCAs and provides clarification for a number of issues. In March 2006, Japan for the first time released guidelines on CCAs that provide a definition and

guidance on the administration of CCAs, the treatment of pre-existing intangibles and appropriate documentation. Also, Australia issued Taxation Ruling 2004/1, which accepts and builds upon the views in Chapter VIII of the OECD Guidelines in the context of the relevant provisions of the Australian income tax law.

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

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

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

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

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

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

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

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

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

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

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

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

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

Looking at the question of whether a profit margin should be added to the pool of costs allocated among the sharers, an earlier report of the OECD concluded that it would normally be appropriate for some kind of profit element to be included, but that it should relate only to the organisation and management of R&D and not the general investment risk of undertaking it, as that risk is being borne by the participants. As noted above, however, Chapter VIII of the OECD Guidelines now focuses upon whether the allocation of costs among the participants reflects the relative benefits inuring to the parties. A profit element is thus no longer to be allocated among the participants in the cost-sharing arrangements.

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

Cost-sharing adjustments

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

Cost-sharing and risk

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

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

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

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

The participants

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

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

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

Establishing cost-sharing arrangements in mid-stream

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

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

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

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

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

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

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

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

The 2008 US temporary cost-sharing regulations also make an important change to the requirements under which reasonably anticipated benefit ratios are calculated for PCTs

and cost-sharing arrangements. There is now an explicit requirement that reasonably anticipated benefit ratios be computed using the entire period of exploitation of the cost-shared intangibles.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Foreign exchange and finance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- starting a business in another country
- financing expansion

- underwriting losses of troubled subsidiaries, and
- determining or establishing a trading account between two affiliates.

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

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

Characterisation of loans

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

Interest on loans

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

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

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

This general principle is used in most countries, but some provide a 'safe harbour'. Consequently, although a provision is made for arm's-length interest rates, if an interest rate falls within a specified range, other factors of comparability will be ignored.
For instance, in Switzerland, the tax authorities have issued required minimum and

maximum rates based on the Swiss market. However, deviations from the rate may be made when the debt is in foreign currency or the difference is modest and the rationale is reasonable. The US also has an extensive system of safe harbours.

Loan guarantees

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

Bona fide leases

Leasing as a form of loan financing is discussed in *Chapter 2 under Lease financing*. The use of a bona fide lease as a means of securing the use of tangible property without bearing the risk of ownership is another type of financing. In this context the transfer pricing rules relating to interest rates are not appropriate. However, rules prescribed by the tax authorities on arm's-length rental rates are minimal. The OECD does not provide guidelines, and most countries do not address the subject, even in a general manner. It is thought that cross-border leasing of equipment (using bona fide leases) is not common practice (being focused mainly on individual, high-value transactions requiring individual treatment), probably because cross-border leasing is commercially complex and raises myriad business and tax issues. For instance, owning equipment located in some countries may create a permanent establishment problem for the foreign-based lessor. In addition, there may be withholding taxes on rentals payable under certain jurisdictions.

Establishing an arm's-length rental rate

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

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

E-business

Introduction

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

Instantaneous transactions across international boundaries – which are quicker, more frequent, often highly automated and involve the greater integration of functions within a multinational group – potentially make it harder to perform a traditional

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

Transfer pricing issues for the business community

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

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

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

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

Issues for tax authorities

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

have used the OECD as the forum to address the issues and produce appropriate international guidance.

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

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

6.

Managing changes to a transfer pricing policy

Introduction

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

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

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

Transfer pricing committee

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

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

The responsibility of the committee is to advise on whether the arm's-length transfer pricing policy that the group has adopted is properly and efficiently implemented and continues to work effectively. It must recommend that appropriate transfer pricing policies are implemented for new products, new geographic markets, etc. The committee's brief will be to monitor changes in the business, whether they be major restructurings made for operational reasons, intended acquisitions, new product lines or changes in operations, and to determine whether the policy is effective or recommend changes that need to be made to correct any deficiencies.

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

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

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

Setting the group's initial pricing policy

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

Active planning of the global tax charge

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

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

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

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

Change in the operating structure of the company

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

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

Parent company pressure

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

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

Tax audit settlements

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

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

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

Problems with current policy

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

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

Making corrections through fine-tuning

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

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

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

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

Massive change: alteration to business reality

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

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

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

Changes in law

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

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

Example

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

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

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

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

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

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

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

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

Dealing with major changes

Occasionally, a transfer pricing policy will not be arm's length and will require major changes. For example, it is not unusual for a parent company to establish transfer prices from its own manufacturing plant to related parties in high-tax jurisdictions using a cost-plus approach. Often, the cost base is standard manufacturing cost. The 'plus' is frequently quite low (e.g. 5% or 10%). If the result of a policy such as this is to produce recurring losses in the manufacturing entity, after deducting overheads and general and administrative expenses, while the sales affiliate is making large profits, it is clear that the transfer pricing policy is not arm's length; no independent

manufacturer would tolerate manufacturing at a loss in this way. If such a policy has been in operation for a number of years and has not created problems with the tax authorities in the manufacturer's country, changing the policy is problematic – particularly because the need for change usually emerges as a result of a crisis. For example, a manufacturing company may experience recurring losses and consequent cash-flow problems. When this happens, the result is a critical need to change the policy to rectify the problem. The issue that must then be addressed is the reaction of the tax authorities involved.

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

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

Year-end adjustment

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

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

Retroactive price changes

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

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

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

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

Defensible late adjustments

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

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

If we take these examples in the context of a group of companies where the parent company is taking a decision to charge all the subsidiaries a management fee, it will

usually be evident from the facts whether a charge made on the last day of the year to cover the whole of the previous 365 days will be acceptable. The questions to be asked are whether the subsidiary requested the service and whether the subsidiary benefited from the service. It is not good enough merely for the parent to have incurred expenses in carrying out work that might or might not have been for the benefit of, or at the request of, the subsidiaries.

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

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

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

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

Timing of changes

The timing of a change in transfer pricing policy, particularly if it corrects an error in a prior policy, is crucial. If an income-tax audit is ongoing at the time the policy change is made, the tax authority might become aware of the change, and it could be alleged that the prior policy was incorrect. This type of evidence is not helpful in settling the audit favourably. It is, therefore, imperative to plan carefully the timing of the implementation of a policy change to minimise the impact on the tax liability for

previous years. This involves weighing the risks for prior years against the potential cost to the company of inaction, in the form of possibly higher tax rates in the future or possible penalties. This analysis is detailed and must be done on a case-by-case basis to arrive at a defensible answer.

'Big bang' or gradual

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

Communicating the changes to the tax authorities

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

Tax return disclosure

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

Accounting disclosure

In some countries, the extent and form of accounting disclosure of a change in certain transfer pricing policies may be prescribed by statute or accepted best practice. However, there is generally some discretion as to the wording in the accounts, which

should be considered carefully because the accounts are likely to be reviewed, certainly by the domestic tax authorities, and possibly by foreign revenue authorities.

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

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

Communicating the changes to employees

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

For example, in the area of management services rendered by a parent company to its subsidiaries, the parent company executives may be quite clear about the nature of the services they carry out for subsidiaries and will also have ideas about the value to the subsidiary of their work. However, executives at the subsidiary company may feel overawed by the parent company or, alternatively, feel that the parent company does not understand their position. Their view of the benefit of the services they receive will therefore be a different one, and in such circumstances it would be enormously helpful for both sides to be clear about what is being provided and why and how the services will be priced. The work involved in documenting these points would follow the course of an ordinary negotiation between parties at arm's length and, if followed, should produce a result that will be fully justifiable and properly understood by all those involved. At the same time, it is not always appropriate to let too many employees know about tax planning initiatives that the parent company is using to manage the worldwide tax burden of the group. Loose lips sink ships' is an old adage that applies

in this area. There are numerous examples of disgruntled former employees who knew only enough about a transfer pricing policy to suggest to the tax authority that a fraud might exist. In such cases, the employee is rarely in a position to know the whole story and, consequently, to understand that no fraud existed at all. The end result can be an awkward situation for the group in dealing with the tax authority. Subject to compliance with local laws that may govern disclosures to employees or trade unions, employees should be told only what they need to know to do their jobs properly and to support policies that directly affect them.

Impact on management/employee bonus schemes

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

Accounting systems

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

The audit trail

Tax authorities are requiring ever-greater amounts of information during their audits. As discussed in Chapter 7, tax authorities (particularly in the US) routinely ask for income statement data by product line and by legal entity to aid in evaluating the appropriateness of transfer pricing policies. This information is also of importance to the group in monitoring and developing its pricing policies, but the level of detail available will vary from company to company. It is particularly important to ensure that data is not lost when policy changes are made, that the transition from old to new

systems is smooth and a full audit trail is preserved. It is also important that companies assess the degree to which accounting data that is not routinely prepared for business purposes may be required by a tax authority in a country in which they do business. In some countries, severe penalties are imposed for failure to provide the data that the tax authority requires. As in many areas of transfer pricing law and practice, the US is by far the most demanding authority in this regard. However, the US approach is gaining increasing credence in other countries, and most companies do not have the accounting systems required to develop these detailed income statements easily. Care must be taken, where possible, to ensure that accounting system enhancement programmes are designed with these criteria in mind. Having these processes built into a company's internal control process is typically best practice.

Documenting the changes

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

7.

Dealing with an audit of transfer pricing by a tax authority

Introduction

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

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

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

Under other jurisdictions (notably the US) a complex framework of extensive resources and procedures has been established to deal with transfer pricing investigations and disputes. In some countries, it has been suggested that the natural inclination of the local tax authority and government would be to apply fairly relaxed transfer pricing principles, only mounting a concerted transfer pricing attack where the prices concerned fall outside a reasonable range. However, the aggressive US approach to transfer pricing has apparently caused these countries (Japan, Korea and Germany are

notable examples) to seek to match the extensive resources devoted to transfer pricing in countries such as the US, UK and Australia, and to legislate to introduce clearer rules on the subject to protect its tax base from predatory tax authorities around the world.

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

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

Establishing control of the audit process

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

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

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

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

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

- A careful plan is established that sets out protocols on how the audit should progress and how liaison with the local tax authority (and overseas authorities) should be handled.

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

Minimising the exposure

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

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

Settling the matter – negotiation, litigation and arbitration

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

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

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

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

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

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

Preparation

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

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

- Any information that is to be provided to the local tax authority (verbal or documented) must be carefully reviewed by the audit team to ensure the following:
- All of the information is correct.
- All of the information is consistent with the tax returns and accounts of the relevant entities and other information which may be available to the local tax authority.

  The positive or negative implications of the information have been fully considered (i.e. does it support the existing pricing structure, and the functional analysis of the relevant entities' activities or does it identify a tax exposure?).

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

Dealing with adjustments to existing pricing arrangements

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

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

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

Advance rulings

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

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

Dealing with an audit of transfer pricing by a tax authority

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

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

8.

Financial services

Introduction

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

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

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

Regulatory environment

Most parts of the financial services industry are subject to significant levels of governmental regulations to protect the integrity of the global financial system as well as consumers. Historically, the regulation has involved myriad rules and regulators at the local country level, although more recently there has been a move towards more consistency at the international level through the development of, for example, the Basel measures[2] by the Bank for International Settlements (BIS) and within the European Union (EU). The US 2010 Dodd-Frank Wall Street Reform Act has imposed a series of restrictions on banks, and to a lesser extent, insurance companies to limit their abilities to engage in risky behaviour. In the wake of the 2008 financial crisis, the OECD, the European Union (EU) and the International Monetary Fund (IMF) concluded that solutions to ensure that the financial sector made 'fair and substantial contributions' to the macro-economy introduced the pathway for 'bank tax levies' that have been adopted and implemented by many European countries over the past

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

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

two years.[3] Such levies raise transfer pricing issues that need to be addressed from a holistic perspective as levy bases are not uniform and tax rates vary significantly across different jurisdictions. The impacts of these regulations materialise, among other things, into the corporate and operating structures that financial institutions have been employing over the past few years.[4] Any transfer pricing analysis should therefore be mindful of such restrictions. Conversely, operating structures accepted by the regulators may provide evidence that the arrangements should also be accepted for transfer pricing purposes.

Global integration

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

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

Complexity and speed

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

Capital

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

3 The objectives of the bank levies were to cover the fiscal cost of the direct public support to financial institutions and help reduce excessive risk taking.
4 The divestiture of risky financial assets of certain banking institutions' balance sheets over the past two years and their subsequent focus on their core banking activity is a prime illustration of such impact.

Branch profit allocation

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

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

Head-office services[5]

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

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

For most tax authorities, these services are an easy and understandable target when analysing transfer pricing within a financial institution. They have transposed into the financial services sector the experience with intra-group service charges they gained and honed in the non-financial service sectors. As such, a shared service is often the first transaction that is queried during a transfer pricing audit. To hedge against undesirable outcomes during a transfer pricing audit, as highlighted in the OECD Guidelines,[6] the transfer pricing documentation of intercompany shared

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

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

services transactions should clearly demonstrate (i) whether services have in fact been rendered and a benefit has been conferred,[7] and (ii) that the intra-group charge for such services is in accordance with the arm's-length principle.[8] Additionally, shareholders activities (i.e., activities considered not beneficial to the recipient) should clearly be identified as they cannot be charged out.

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

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

IT services[9]

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

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

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

However, the 2008 financial crisis has increased the focus on risk assessment and has therefore raised the stature of middle-office applications. In addition, the reach and

7 In general, an activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position or that may reasonably be anticipated to do so. On the other hand, for an indirect or remote benefit, the service is not considered to provide a benefit to the recipient.
8 The OECD Guidelines identify two arrangements by which organisations seek to charge for intra-group services: the Direct Cost Method and the Indirect Cost Method.
9 Please refer to PwC's April 2012 *'Clarifying the rules; Sustainable transfer pricing in the financial services sector'*, for additional details.

life of the technology will most likely become contentious points of discussion under a transfer pricing audit.

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

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

Funding considerations[10]

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

Going forward

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

Banking and capital markets

Introduction

From the traditional lending of funds and financing of trade flows, banks' activities have extended to retail deposit-taking, lending, credit cards and mortgages to private client wealth management, commercial loans, asset-backed financing and financial risk management products, and into capital markets' activities including equity brokerage, bond dealing, corporate finance advisory services and the underwriting of securities.

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

Financial services

Over the last century, banks and capital markets' groups have expanded across the globe, in part to service their internationally active commercial clients and in part to track the flow of capital from developed countries to newer markets in search of higher returns.

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

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

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

Global trading

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

Under both sets of guidelines, a global trading operation involves the execution of customer transactions in financial products where part of the business takes place in more than one jurisdiction and/or the operation is conducted on a 24-hour basis. A simple example would be where a salesperson in one country introduces a customer to the trader located in another country who is responsible for trading the relevant financial product followed by the execution of the customer transaction by the trader. Because of the inherent complexity of the transactions at stake that typically involve

a mix of technology, sophisticated trading skills and unfold across multiple tax jurisdictions, the design and documentation of transfer pricing policies continue to be extremely complex and challenging in this context.

Historically, given the large amounts at stake, many multinational banks have resorted to advance pricing agreements/advanced pricing and mutual agreements (APAs/APMAs) as a way of addressing the uncertainty resulting from pricing this type of activity. Adopting an APA/APMA approach has its own risks, including the potential mismatch between the speed with which global trading businesses develop and the length of time an overall APA process might take. It is also a time-consuming and

11 Treasury Regulations *'Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged in a Global Dealing Operation'*, March 1998.

12 OECD Reports Part III, July 2010.

resource intensive exercise and the practical difficulty of negotiating APAs across more than a few jurisdictions might appear particularly daunting at times. Recent developments from fiscal authorities in the US and Europe indicate that taxpayers' concerns over the difficulties of the APA process have been acknowledged and attempts to respond in a pragmatic fashion have been implemented.

Fee-based businesses

Fee-based businesses range from relatively high-volume, low-fee-based businesses such as equity brokerage to the relatively low-volume, high-fee-based businesses such as corporate finance advisory activities and the management, underwriting and distribution of new issues of securities for clients.

Even within such well-established businesses as equity brokerage, there can be a wide range of operating structures within a group and a significant variety of products and services provided to clients. Substantial differences may also exist between the products, markets and exchanges of different countries, including not only in the volatility and liquidity of products but also, for example, in the settlement risks and costs involved. Difficulties can also arise in extrapolating from data on relatively small trading volumes to potentially much larger volumes handled within a group.

The relatively low-volume, high-fee-based businesses can be particularly challenging from a transfer pricing perspective, particularly as many of the transactions are unique. Several years may have been spent investing in a client relationship before a structured transaction emerges and when it does, specialists from several countries with different expertise may be involved in the final transaction.

Treasury and funding

The funding of a bank, both on a short-term basis, for example to meet withdrawals by depositors and to fund new loans, and on a longer term basis as part of the overall management of the capital of a bank, is an intrinsic part of the activities of a bank. Although many of the transfer pricing issues surrounding financing transactions apply equally to intragroup funding within banking groups, the nature, amount and term of internal funding has been significantly affected by the latest changes in the regulatory environment along with the available liquidity in the marketplace post the 2008 financial crisis. For banks operating in the US, the advent of the Volcker Rule, a section of the Dodd-Frank Act which prohibits banks from engaging in proprietary trading and from owning and investing in a hedge fund or private equity fund, has triggered funding reallocations across banks' businesses lines impacting the operating structures for raising and managing funds. Given the sensitivity of tax authorities towards funding transactions, even straightforward money market transactions or repurchase transactions must be carefully examined to ensure that each party to the transaction is remunerated according to the arm's-length standard.

Cross-border services

As alluded to above, banking and capital markets groups generally undertake many centralised activities (i.e. management services), including inter alia the provision of central human resources, legal, accounting, internal communications and public relations' activities. The past few years have witnessed an increase in the number and quality of the tax administrations' audits related to the allocations, across business participants, of such expenses. A number of Asia-Pacific, European and US tax authorities have recently devoted a significant amount of resources auditing such

transactions and paid a particular attention to the characterisation of the services provided, the identification of the benefits conferred, the costs associated with the provision of the services and the profit elements attributable to the service providers.

In response to the financial crisis, actors in the banking sector have increasingly centralised their credit and market risk management activities along with their regulatory compliance and reporting ones. In addition, banks are also often heavily reliant on partially developed IT systems, communication links and external data feeds leading to challenging transfer pricing issues revolving around the pricing of the technology used and the allocation of its costs.

Other issues in banking and capital markets

The above comments are by no means exhaustive. Other important but difficult issues include the transfer pricing treatment of relationship managers. Developments in the banking sector have resulted in an increasing focus on trading and fee-based activities leading to corresponding changes in the perception of the role of general banking relationship managers. This in turn leads to a more difficult question of whether the relationship management function remains an originator of wealth or has perhaps become merely a consumer of cost.

Similarly, research has historically been treated as an overall cost to a business. Developments since the late 1990s suggest that the role of research may need to be reassessed as the market for research becomes increasingly sophisticated and independent from the multinational group, leading in some cases perhaps to a potential comparable uncontrolled price (CUP) approach.

Credit derivatives is another area where there have been significant developments recently, not only in the trading area where customers have been increasingly willing to purchase protection and lower their credit exposure but also in the use of credit derivatives internally by banking groups, for example as part of the centralised management of credit risks associated with loan portfolios.

Insurance

Introduction

An insurance policy is a contract that binds an insurer to indemnify an insured against a specified loss in exchange for a set payment, or premium. An insurance company is a financial entity that sells these policies.

Insurance policies cover a wide range of risks. Broadly, these can be classified as:

- general insurance (motor, weather, nuclear, credit), and
- life insurance (pension, term).

The major operations of an insurance company are underwriting, the determination of which risks the insurer can take on and rate-making, the decisions regarding necessary prices for such risks, claims management and appropriate investment of the sizeable assets that an insurer holds. By investing premium payments in a wide range of revenue-producing projects, insurance companies have become major suppliers of capital, and they rank among the largest institutional investors.

Reinsurance

Reinsurance is insurance purchased by insurers. Under a reinsurance arrangement, the reinsurer agrees to indemnify an insurer (known as the cedant under a reinsurance contract) against part or all of the liabilities assumed by the cedant under one or more insurance or reinsurance contracts.

In consideration for reinsuring risks, the ceding insurance company pays a premium to the reinsurer. Although reinsurance does not legally discharge the primary insurer from its liability for the coverage provided by its policies, it does make the reinsurer liable to the primary insurer with respect to losses sustained under the policy or policies issued by the primary insurer that are covered by the reinsurance transaction.

Reinsurance is generally purchased to enhance the risk diversification of the insurers' portfolio, to stabilise their annual results, and to increase efficiently their premium-writing capacity.[13] It may also be used to facilitate the growth of an insurer's new products or aid its entry into new lines of business.

The two methods by which risk is ceded through reinsurance contracts are:

- Treaty reinsurance – A contractual arrangement that provides for the automatic placement of a specific type or category of risk underwritten by the primary insurer.
- Facultative reinsurance – The reinsurance of individual risks whereby the insurer separately rates and underwrites each risk. Facultative reinsurance is typically purchased by primary insurers for individual risks not covered by their reinsurance treaties, for excess losses on risks covered by their reinsurance treaties and for 'unusual' risks.

The two major forms of reinsurance are proportional reinsurance and excess-of-loss reinsurance. Premiums received from treaty and facultative reinsurance agreements vary according to, among other things, whether the reinsurance is on an excess-of-loss or on a proportional basis.

- Proportional reinsurance – The two types of proportional insurance are:
    - Quota share – The risk is shared according to pre-agreed percentages.
    - Surplus share agreement – The primary insurer selects the amount of liability it wishes to retain on the policy and then cedes multiples, known as 'lines', of its retention to the insurer. Losses and premiums are divided between the company and the reinsurer proportionally with respect to the portion of risk undertaken.
- Excess-of-loss reinsurance – The reinsurer indemnifies the primary insurer for all covered losses incurred on underlying insurance policies in excess of a specified retention. Premiums that the primary insurer pays to the reinsurer for excess of-loss coverage are not directly proportional to the premiums that the primary insurer receives, because the reinsurer does not assume a proportional risk. Furthermore, the reinsurer generally does not pay any ceding commissions to the primary insurer in connection with excess-of-loss reinsurance.

13 An insurer's gross underwriting capacity (i.e. its ability to write business) is limited by law or regulation based on the amount of its statutory surplus. The greater the ratio of premiums written or liabilities to such surplus (i.e. its leverage ratio), the less likely it is that the regulator will consider the surplus to be sufficient to withstand adverse claims experience on business written. Through reinsurance, an insurer can increase its gross volume of business written, while maintaining a healthy ratio between risk retained and surplus.

A company that provides reinsurance can, in its turn, engage in an activity known as 'retrocession'. Retrocession is defined as a transaction in which a reinsurer cedes to another reinsurer all or part of the reinsurance it has previously assumed. The ceding reinsurer in a retrocession is known as the 'retrocedent', while the assuming reinsurer is known as the 'retrocessionaire'.

Intragroup reinsurance arrangements are typically the most material transfer pricing transactions for most insurance groups and therefore a focal point for governments and tax authorities around the globe. Over the past few years, the transfer pricing environment surrounding insurance and reinsurance transactions has evolved such that, when conducting a transfer pricing analysis, special care should be taken to ensure that (i) capital requirements are being met by the insurers and (ii) the substance of the transactions is carefully documented.

In 2009, the European Union enacted the Solvency II directive thereby introducing economic risk based solvency requirements which have led to an increased consolidation within the industry to take advantage of the synergies and economies of scale and an increase appetite for companies to operate through branches. This in turn raises significant transfer pricing challenges in light of the July 2010 OECD Part IV publication on the attribution of profits to permanent establishments of insurance companies.

In the US, the 2011 Neal Bill (a revised version of the so-called 2009 Neal Bill) was introduced with the intent of eliminating the deductions for reinsurance premiums paid by a US insurance company to its off-shore non-taxed related affiliates. As a consequence, although many group reinsurance companies still reside in jurisdictions with benign tax and regulatory regimes, such as Bermuda, an increasing number of those have now chosen to establish their operations in treaty countries.

As described above, reinsurance transactions are generally complex in nature and many contracts are bespoke to address the particular requirements of both the reinsured and the reinsurer. Transfer pricing support typically comprises a combination of the following approaches:

Commercial rationale: The first requirement in support of a reinsurance arrangement is to demonstrate the commercial rationale behind the transaction. Tax authorities can seek to re-characterise the transaction if it would clearly not have been entered into with a third party. This is particularly critical given the OECD members' current focus on an anti-avoidance agenda in respect of reinsurance transactions and business restructuring.

Internal CUPs: In some cases, a group reinsures portions of the same business to related and unrelated parties, which may provide a strong CUP. In other cases, a group may have previously reinsured with an external reinsurer before establishing a group reinsurer. Care needs to be taken to demonstrate that the contracts are comparable, taking into account the mix of business, layers of risk, volume, expected loss ratios, reinsurance capacity, etc.

Pricing process: For complex non-proportional reinsurance, the most appropriate transfer pricing support may often be derived from being able to demonstrate that the pricing process for internal reinsurance contracts is exactly the same as that for external reinsurance. This involves due diligence on the actuarial modelling and

underlying assumptions, as well as the underwriting decision, which evidences the process of negotiation, challenge and agreement on the final price. The use of this approach has been strengthened by the US services regulations, which expanded the indirect evidence rule by reference to an insurance-specific example.

Cost of capital: Many large proportional reinsurance contracts are difficult to price using either of the above methods, as they often involve multiple classes of business that are not commonly found in the marketplace. In such cases, it is often necessary to return to first principles and address the capital requirements and appropriate return on capital based on the expected volatility and loss ratios of the portfolio of business, as well as the cost of acquiring and supporting the business, thereby addressing the pricing from both the cedant's and reinsurer's perspectives. Additionally, ratings agencies may provide guidance and support for the pricing process through the benefits in the sources and uses ratio due to capital relief obtained through reinsurance transactions.

Centralisation

Insurance groups generally undertake many centralised activities (i.e. management services), including inter alia the provision of central human resources, legal, accounting, internal communications and public relations' activities. The past few years have witnessed an increase in the number and quality of the tax administrations' audits related to the allocations, across business participants, of such expenses. European and US tax authorities have recently devoted a significant amount of resources auditing such transactions and paid a particular attention to the characterisation of the services provided, the identification of the benefits conferred, the costs associated with the provision of the services and the profit elements attributable to the service providers.

Specific centralisation issues can also arise when global insurance policies are sold to multinationals where negotiation, agreement and management of risk occur at the global or regional head-office level. In such cases, even where the local insurance company/branch is required to book the premium, the reality may be that the local entity is bearing little or no risk. Alternatively, where risk is shared among the participants, consideration needs to be given to how the central costs of negotiation should be shared.

Investment and asset management

The return earned from investing the premium collected contributes to the ability of insurance companies to meet their claims obligations. To the extent that such investment and asset management capabilities are concentrated in certain parts of the overall group, a charge is made for the services provided to other members of the group. Specific factors that may influence the pricing of such services include the type of assets managed, level of activities carried out, risk involved, volume of transactions, expected returns and expenses of providing such services.

The specific issues to be considered are described in more detail in the *Investment Management* section below. However, it is worth noting here that, as insurance groups often have very large sums to manage and the level of funds under management represents a key business factor in pricing investment management services, comparables used in the broader investment management sector may need to be adjusted for the sale of invested assets before being applied within an insurance group.

Financing and financial guarantees

As with banking, many of the issues surrounding financing transactions apply equally to intragroup financing within insurance institutions. These include intragroup loans and loan guarantees. However, certain financing issues are specific to the insurance sector.

The provision of financial guarantees is an important aspect of insurance transfer pricing. Such guarantees can include claims guarantees, net worth maintenance agreements and keep-well arrangements. Pertinent factors that need to be considered include the type of security or collateral involved, the differential credit ratings between guarantee providers and recipients, market conditions, and type and timing of the guarantee.

Brokerage and agency activities

With the increasing internationalisation and consolidation in the insurance sector, insurance brokers and agents are becoming increasingly integrated. As such, brokerage/commission sharing becomes increasingly complicated, resulting increasingly in the use of profit split as a primary or secondary supporting method to adequately represent each participant's contributions.

Other issues in insurance

Insurance companies are increasingly expanding into new areas of business, with a view to diversifying the risks associated with the modern insurance industry. As a result, we are seeing insurance groups undertake many of the activities that have traditionally been associated with the banking and capital markets industry. The resurgence of insurance derivatives is part of the general trend of using capital markets solutions to solve insurance industry problems. Transfer pricing associated with the trading of insurance derivatives often raises similar issues described above for global trading within banks, as discussed above.

One specific issue that arises reflects the history of insurance groups. As insurance groups have grown, typically through acquisition, complicated group structures and non-standard transactions have arisen as a result of regulatory restrictions and historical accident. Understanding the history behind such transactions often plays an important part in explaining how the transfer pricing approach must be evaluated within an appropriate commercial context.

Investment management

Introduction

Investment management activities permeate the entire financial services industry. Insurance companies have a core need to manage their funds, and banks, following the enactment of the Volcker Rule, have been searching for new investment channels to manage the capital they used to devote towards their own proprietary trading desks. Although many investment management businesses are still part of a wider banking or insurance operation, there is also a significant number of independent investment management firms whose sole business it is to manage assets on behalf of their clients. In all cases, assets are reinvested on a segregated basis or, more commonly, on a pooled basis through the medium of a notional or legally distinct investment fund.

The diverse and global nature of the investment management industry gives rise to a huge variety of investment fund types. Fund types include securities or bond funds, hedge funds, property funds, private equity funds, futures and options funds, trading funds, guaranteed funds, warrant funds and fund of funds. These funds can be further subdivided into different share or unit classes incorporating different charges, rights and currency classes.

Within each type of fund are different strategies of asset management. Investors select funds based on performance and their aversion to risk. Funds can either passively track an index or be actively managed. Indexed funds or trackers are benchmarked to a defined market index. The fund managers are passive insofar as they do not attempt to outperform the index through stock selection. This contrasts with the actively managed fund where the managers select assets with the aim of outperforming the market or the benchmark. As a result of these strategies, different remuneration schemes for the investment managers have been devised to adequately reflect their contributions to the overall performance of the funds.

Factors such as the increasing mobility of capital and technical advances in the field of communications have contributed to the large number of jurisdictions with thriving investment management industries. In many cases, investment managers offer services from offshore domiciles to investors in selected target countries for certain legal, regulatory or tax requirements. Investment advisory, marketing and fund-accounting services are often then delegated to onshore subsidiaries, which benefit from better access to a skilled workforce.

Fees for managing assets are typically charged on an *ad valorem* basis (i.e. as a percentage of assets under management) and have recently decreased due to the increasing competition in the industry. However, charges and charging structures still vary depending on the nature of the funds in which the investment is made, the investment profile of the fund, the investment objectives themselves, and the brand name recognition surrounding the investment manager. Private equity and venture capital vehicles may charge investors based on the committed capital pledged to the investment vehicle over time.

Investment funds can give rise to a number of different charges for investors, including:

Front-end loads: A charge made on the monies committed by an individual investor on entering the fund and paid by the investor. This is common in retail funds where an independent financial advisor (IFA) brings clients' monies to the fund and, in return, expects a proportion of the load.

Management fees: A charge (usually a fixed percentage) made on the net asset value of the fund and paid directly by the fund to the fund manager.

Trailer fees: A fee payable to distributors (e.g. IFAs) by the fund manager from the gross management fee for the referral of clients' monies. The fee is normally calculated as a proportion of the net assets referred by the distributor and is usually payable by the fund manager until the investor withdraws their monies.

Performance fees: Fees typically paid in addition to a base management fee by niche market funds (e.g. hedge funds and private equity funds) as well as for the

management of large segregated funds. The industry recognises three broad classes of investors: institutional, retail and private client.

Below, the main investment management sub-industry categories involving significant cross-border flows of products and services are considered in more detail.

Asset management

Asset management typically comprises overall asset allocation and the asset research, selection and management of individual securities, with a view to meeting the objectives of the portfolio or fund. It is common for these functions to be segregated to take advantage of local/specialist knowledge and expertise (commonly referred to as subadvisors).

Investment management groups may have potential internal comparables relating to institutional mandates. In addition, there is some publicly available information in respect to both investment management and subadvisory fees. These should be used carefully, since specific factors influence the pricing of such services, including the type of assets managed, scope of activities carried out, risk involved, volume of transactions, expected returns and expenses of providing such services.

Marketing, distribution and client servicing

In considering appropriate arm's-length fees for marketing, distribution and client servicing, one of the most important considerations is the type of customer. For example, fees are usually higher for retail investors than for institutional investors. This reflects both the additional costs associated with attracting funds for retail investors and also the greater bargaining power of institutional investors, due to their larger size of investment. Again, owing to the different business models applicable to different types of customer, funds and investment strategy, great care needs to be taken in attempting to make use of potential comparables – internal and external. Industry intelligence and anecdotal evidence should be accounted for in the comparable analysis as financial arrangements for distribution and capital-raising services are often highly discrete or depend on the type of client and asset class managed.

Administration and other centralised activities

As for banking and insurance groups, investment management groups or subgroups generally undertake many of the same types of centralised activities (i.e. management services), including inter alia the provision of central human resources, legal, accounting, internal communications and public relations' activities. The considerations highlighted in the context of the banking and insurance industries relating to the identification of the services provided, the entities providing the services, the entities receiving the services, the costs involved and the application of a markup apply equally here.

Consideration needs also to be given to the development of bespoke investment technologies, which act to enhance investment performance or to centralise risk and decision-making. In addition, the track record and skills of the portfolio managers are highly important in the investment management business, while the ownership and development of brand and other intangible assets needs to feature prominently in any transfer pricing analysis.

In 2011 and 2012, the alternative investment industry performance rebounded significantly from the post 2008 financial crisis era and is expected to keep growing at a superior pace in the foreseeable future. Despite the recent performance trend, investors have maintained a significant amount of pressure on fees they are willing to pay to fund managers. As in the case of the insurance industry, the major factors currently affecting the industry are globalisation, structural changes, and changes in the capital market regulatory environment.

With new regulations in place (i.e. the 2010 Dodd-Frank Act, BASEL III) to prevent future credit crisis and market collapses, certain types of business activities have been restricted affecting the future profit, revenue, and assets of management of the industry. More stringent capital and liquidity standards have been proposed, which will hamper risk-taking or liquidity in the capital markets and increase compliance costs in the banking industry leading investors to turn to less regulated environments. Further, the Volcker Rule, scheduled to go into effect in July 2014, by prohibiting banking entities from (i) investing in or sponsoring private equity funds, venture capital funds or hedge funds or from (ii) conducting proprietary trading is likely to increase the industry's assets under management as investors seeking high returns will go to hedge funds and private equity firms once they become the only source of relatively unrestricted capital left in the market. Additional regulations aimed at regulating the alternative investment industry (i.e. the European Alternative Investment Fund Managers Directive) will likely increase the compliance burden of European investment funds while decreasing the number of non-European investment managers operating in Europe and therefore the overall competitiveness of the European market.

As these ongoing changes unfold, tax authorities have recently increased their number of transfer pricing audits mainly in relation to the remuneration of offshore managers. Additional considerations such as the value-added tax impacts, when relevant and possible, should be weaved into the transfer pricing policies as these represent expenses for the investment managers.

Real estate

In the wake of the 2008 financial crisis, institutional investors have increased their allocations into the real asset market as sales of distressed real estate assets by banks have boosted the availability of prime properties in key locations. However, given the recent market events, investors are now requiring more frequent reporting on the assets they invest in and also request higher transparency. The coming years will continue to witness significant major regulatory changes as regulators keep on focusing on investor protection and harnessing systemic risks. To cope with these challenges, constraints and increasing costs pressure, real estate fund managers have been rethinking their business models and organisational structures. The concomitance of these trends has enhanced the visibility of the industry in the eyes of tax authorities around the world in general and in the US, in particular where an investment vehicle, the real estate investment trust (REIT) has risen to prominence due to its preferential tax treatment.

A REIT is a 'pass-through' entity that can avoid most entity-level federal tax by complying with detailed restrictions on its ownership structure and operations. As such, its shareholders are taxed on dividends received from the REIT but the entity itself is generally not subject to taxes as it generally redistributes all of its income in the form of dividends. A taxable REIT subsidiary (a TRS) provides a REIT with the ability

to carry on certain business activities that could disqualify it if engaged in directly by the REIT.

Transactions between a REIT and its TRS are analysed under the section 482, transfer pricing regulations and subject to the arm's-length standards. Such transactions include providing services to tenants, sharing resources, leasing transactions and financing transactions. In developing these investment structures, the challenges are (i) to determine the right mix of debt and equity and setting the appropriate interest rate on the debt component, and (ii) to ensure that the ancillary services performed by the TRS are appropriately remunerated as available third party comparables are typically difficult to obtain.

Sovereign wealth funds (SWF)[14]

Over the last decade as nations become richer and increasingly wiser about financial planning, the number and the wealth of the SWFs have dramatically increased. From an international tax standpoint, there is no conventional definition of an SWF. Generally, the term refers to a state-owned fund invested into a variety of financial assets (stocks, bonds, real estate, commodities, and other financial instruments). Conceptually, the SWF is only one of the types of investment vehicles used by sovereign states to invest their accumulated wealth, along with public pension funds, state-owned enterprises or sovereign wealth corporations.

An understanding of the functional profile of the sovereign wealth funds is fundamental to the understanding of transfer pricing matters for SWFs. Generally, in the asset management market, SWFs are unique in that they are established, funded by, and managed under mandates designed by a sole shareholder, the sovereign state. Each fund has its own unique reasons for creation, source of funds, and objectives. Depending upon the tax laws of the home country or the structure of the investments, some SWFs may be tax exempt. Given state ownership, many SWFs do not publically report investment activity.

Sovereign investment corporations have certain unique features that make them different from non-sovereign investment houses – they are established, funded by, and managed under mandates designed by a sole shareholder (the sovereign state), have large pools of assets under management, and may receive special tax treatment. They also have features that make them similar to non-sovereign investment managers – they operate as independently managed commercial investment companies, are managed on commercial principles to create and maximise long-term value to their shareholders, and are subject to the same competitive market pressures as any other player. They also operate through affiliates established around the world, as relevant to their mission, to enhance their visibility into the opportunities offered by the regional markets and to facilitate their investments.

From a business operational standpoint, the relationships between affiliates and the parent sovereign investment companies are structured in the same way as the inter-company relationships of any other multinational. These transactions may consist of one or a combination of business management services, business support services, market research services, investment advisory services, loan origination services,

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

licensing of intellectual property, inter-company financing, and other types of inter-company transactions.

Although the transfer pricing method and concepts are the same as those available for the analysis of mainstream investment managers, because of the unique structure of SWFs, the challenge is often the selection and use of the pricing data available in the public domain, assuming the CUP method is the best/most appropriate method, and how to determine the necessary adjustments. However, various public databases provide industry-specific data for separate accounts and fund of funds to construct robust benchmark ranges of advisory fees, and to appropriately adjust these ranges (if such adjustments are possible) to reflect primarily the substance of the inter-company advisory functions for a single sovereign investor.

Financial services

9.

Transfer pricing and indirect taxes

Customs duty implications

Goods moved across international borders and imported from one customs' jurisdiction into another are potentially subject to customs duties and, in some cases, to other duties and taxes such as value added tax (VAT) (which are beyond the scope of this book). In determining the transfer price for such goods, consideration must be given not only to the corporate income-tax repercussions but also to the customs duty implications and, in certain circumstances, there may be an apparent conflict between the treatment of a transaction for the purposes of the two regimes. Careful planning is then necessary to achieve a price that satisfies the requirements of the tax and customs authorities without incurring excessive liabilities.

WTO Valuation Agreement

Most countries levy *ad valorem* duties and have complex regulations governing the determination of the value of imported goods for customs' purposes. All references in this book to customs' valuation (unless otherwise stated) are to the World Trade Organisation (WTO) Agreement on implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the WTO Valuation Agreement), formerly known as the GATT Customs Valuation Code. Under the Uruguay Round Agreement, all members of the WTO were required to adopt the WTO Valuation Agreement within a specified period; however, some developing countries have not done so. Nevertheless, the laws of most trading countries are now based on the WTO Valuation Agreement.

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

- they are officers or directors of one another's businesses
- they are legally recognised partners in business
- they are employer and employee
- there is any person who directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them
- one of them directly or indirectly controls the other[1]
- both of them are directly or indirectly controlled by a third person
- together they directly or indirectly control a third person, and
- they are members of the same family.

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

Transfer pricing and indirect taxes

Relationship between customs and tax rules

Although the customs valuation rules are broadly similar to the OECD transfer pricing rules discussed elsewhere in this book, there are some significant differences and it cannot be assumed that a price that is acceptable to the revenue authorities will necessarily also conform to the customs' value rules.

At a basic level, a tax authority focuses on the accuracy of a transfer price as reflected on a tax return (annual basis aggregated across the entire business). Conversely, a customs' authority applies duties against the value of the merchandise at the time of entry into a customs' territory (at a transactional level, product type by product type). Consequently, an immediate potential conflict arises.

In addition to this inherent difference, the two governmental authorities (tax and customs) are working at cross-purposes. On the one hand, a low value for customs' purposes results in lower duties, while, on the other hand, this same low value results in a higher income/profit in the country of importation and results in higher taxes.

Although variations on the same theme, value for transfer pricing and for customs' purposes share a common founding principle: the price established for goods traded between related parties must be consistent with the price that would have been realised if the parties were unrelated and the transaction occurred under the same circumstances. This principle is colloquially known as the arm's-length principle.

Intangibles

Import duty is not normally applied to the cross-border movement of intangible property. However, the value of intangibles may form part of the customs' value of imported goods if they both relate to, and are supplied as, a condition of the sale of those goods. Consequently, some commissions, certain royalties and licence fees, contributions to research and development (R&D), design, engineering and tooling costs, and other payments made by the buyer of the imported goods to the seller may be subject to duty if certain conditions are fulfilled. Conversely, certain costs and payments that may be included in the price of imported goods are deductible in arriving at the customs' value or can be excluded if they are invoiced and/or declared separately from the goods themselves.

The Brussels' definition of value

Those few countries that do not subscribe to the WTO Valuation Agreement (typically developing countries such as Côte d'Ivoire and Montserrat) continue to rely upon an older international code – the Brussels' definition of value (BDV) – which is based on the principle of an entirely notional 'normal' value. Under the BDV, there need be no connection between the customs' value and the price paid for the goods, so that the customs implications of importing goods into these countries have little or no significance for transfer pricing.

Specific duties and fixed values

Not all products are assessed a duty based on their value. Some products are assessed specific duties (e.g. a fixed amount per gallon/litre). In addition, some countries (e.g. Lebanon and Sri Lanka) levy specific duties on certain categories of imported good so that the actual price paid for them does not impact the duty owed. It is important to note, however, that many countries require the value declared to be 'correct', regardless of whether it impacts the amounts of duty paid, and have penalty provisions

for 'non-revenue loss' violations. Similarly, some countries apply fixed or official minimum values for certain goods, which also makes the transfer price irrelevant as a method of determining the value of imported goods for customs' purposes. However, these latter practices are gradually disappearing as the countries concerned adopt the WTO Valuation Agreement.

Sales taxes, value added taxes and excise duties

Generally, the value of imported goods for the purposes of other *ad valorem* duties and taxes tend to follow the value for customs' purposes. There are, however, special rules in many countries and, while a detailed discussion of these is outside the scope of this book, these rules must be taken into account when planning a transfer pricing and business policy.

Antidumping duties/countervailing duties

Anti-dumping duties are levied when, as the result of a formal investigation, it is determined that domestic producers have been or may be damaged because imported goods are sold in the country in question at less than a fair value, having regard to the price at which the same goods are sold in the country of export or, in certain cases, in a third country. In theory, it may appear that, if goods are sold at a dumped price, that price will not be acceptable to the revenue authority in the country of export, although the revenue authority in the country of import would presumably have no problem with it. In practice, however, because dumping is a product of differentials between prices in two markets, it is possible for a transfer price to offend the anti-dumping regulations while being acceptable to the revenue authorities or vice versa. Although, the need for the aggrieved industry to make its case and the administration to be satisfied that the dumping is causing injury mean that dumped prices do not necessarily result in the imposition of anti-dumping duties.

Whereas anti-dumping duties are assessed against companies for their business practices, countervailing duties are assessed based on government subsidies or assistance. These cases target the actions of all trading entities in a particular industry, which are receiving some kind of export-generating assistance from the government of the exporting country. As with anti-dumping duties, the government subsidies can impact the transfer price of goods by removing some of the costs from the price of the exported goods. Accordingly, the transfer price would then be artificially low. However, and as is the case with anti-dumping duties, the aggrieved industry must bring forth the case to the importing country's government. The complainants must show that they have been harmed or will be harmed by the abnormally strong trading position of the entities that received the government subsidies.

Establishing a transfer pricing policy – technical considerations

Where the proposed transfer pricing policy relates to international movements of goods that attract customs duties or other taxes on imports, it is necessary to determine whether the policy will:

- meet the requirements of the customs authority in the country of importation, and
- create opportunities for tax and customs' planning to reduce the values for customs purposes without prejudice to the transfer pricing policy.

Transfer pricing and indirect taxes

When traders use the transfer price as the value for customs' purposes, they exercise an option that is both convenient and rife with pitfalls. The parties to the transaction must be able to demonstrate that, at the time the customs' value was reported, supporting documentation was available to demonstrate that the transfer price was determined using acceptable valuation methods and applicable data. In essence, the customs' value reported by related entities must mimic that which would have been established in an arm's-length transaction according to customs' rules. It is interesting to note that several customs' authorities have issued written guidance specifically stating that a transfer pricing study, in and of itself, is not sufficient to support customs' value requirements.

Adjustments

Before attempting to validate the transfer price for customs' purposes, it may be necessary to make certain adjustments to deduct those items that can be excluded from the customs' value of the goods, even though they are included in the price, and to add those items that must be included in the customs' value, even though they are excluded from the price.

- Costs and payments that may be excluded from the transfer price of goods when included in such price include the following:
- Costs of freight, insurance and handling that are excluded by the regulations of the country of importation (these costs are not always excludable).
- Costs that relate to such activities undertaken after the goods have left the country of export.
- Import duties and other taxes (including sales and value added taxes and excise duties) that are levied on importation of the goods into the country of import.
- Charges for construction, erection, assembly, maintenance or technical assistance undertaken after importation on goods, such as industrial plant, machinery or equipment if separately itemised.
- Charges for the right to reproduce the imported goods in the country of importation.
- Buying commissions.

Certain costs may be excluded from the customs' value if they are separated from the price of the goods. The method of excluding these costs and payments – known as price unbundling – is explained later.

It is important to note that there may also be other costs and payments that must be included in the customs' value (added to the price) of the goods when not included in the transfer price. The costs and payments that must be added to the transfer price for customs' purposes (if they are not already included) are as follows:

- Commissions (other than buying commissions).
- Freight, insurance and handling charges up to the point designated in the rules of the country of import (this can vary by country).
- Royalties, if they both relate to the imported goods and the underlying rights were sold as a condition of the sale of the goods by the supplier (this also can vary by country).
- Assists (i.e. the value of goods and services provided free of charge or at a reduced cost by the buyer to the seller for use in connection with the production or sale of the goods).

- Any quantifiable part of the proceeds of resale of the goods by the buyer that accrue to the seller (other than dividends paid out of the net profits of the buyer's overall business).
- The value, if quantifiable, of any condition or consideration to which the transfer
- price is subject as per the rules of the country of import.
- Any additional payments for the goods, which are made directly or indirectly by the buyer to the seller, including any such payments that are made to a third party to satisfy an obligation of the seller.
- The cost of containers treated as one with the imported goods.
- The cost of labour and materials in packing the goods.

Validation of the transfer price for customs purposes

The WTO Valuation Agreement provides quantitative and qualitative criteria for validating a price of goods. The quantitative criteria defined below are, however, dependent upon the existence of values for identical or similar goods that have already been accepted by the customs' authority in question (or, in the case of the EU, by a customs' authority in another member state). In practice, therefore, unless there are parallel imports into the same customs' territory by buyers not related to the seller, these criteria are not applicable. The quantitative criteria are:

- The price paid approximates closely to a transaction value in a sale between a seller and unrelated buyer at or about the same time.
- The price paid approximates closely to the customs' value of identical or similar goods imported into the same customs' territory at or about the same time.

The qualitative criteria are not specifically defined, although the explanatory notes to the WTO Valuation Agreement do provide some examples. Essentially, the customs' authority must be satisfied that the overseas' supplier and the importer trade with each other as if the two parties were not related. Any reasonable evidence to this effect should be sufficient, but the following circumstances, in particular, should lead the customs' authority to conclude that the price has not been influenced by the relationship:

- The price is calculated on a basis consistent with industry pricing practices.
- The price is the same as would be charged to an unrelated customer.
- The price is sufficient for the seller to recover all costs and make a reasonable profit.
- The use of an alternative method of valuation (e.g. deductive or resale-minus method) produces the same customs' value.

If the application of any of the above criteria confirms that the proposed transfer pricing policy yields transaction values that are acceptable values for customs' purposes, no further action is necessary other than to determine whether any adjustments need to be made to the price and whether prior application should be made to customs for a ruling.

Since the objective of the tax and customs' rules is to arrive at a price that is not influenced by the relationship between the parties, there should be no substantial difference between a transfer price that meets the requirements of both tax authorities and one that constitutes an acceptable transaction value for customs' purposes. However, given the degree of flexibility inherent in both sets of rules, some variation is inevitable and, in certain cases where this flexibility has been exploited for commercial

or income-tax purposes, the difference may be sufficient to result in a transfer price that is unacceptable to the customs' authority or results in an excessive liability to customs' duty.

Transfer prices below the acceptable customs value

If none of the methods described above enables the transfer prices to be validated for customs' valuation purposes, because they are lower than the acceptable value, the taxpayer has the following options:

- Modify the transfer pricing policy.
- Submit valuation for customs' purposes on the basis of an alternative method of determining value.

The choice between these two options depends upon the circumstances in each case, but the following factors need to be considered:

- The interest of the customs' authority in the country of import is, in principle, the same as that of the revenue authority in the country of export: both are concerned that the transfer price may be too low. A transfer pricing policy that produces prices unacceptable for customs' purposes, may, therefore, not be acceptable to the exporting country's revenue authority.
- The methods of validating a transfer price are based, for the most part, on the application of the alternative methods of valuation to determine whether their use will yield a customs' value that is significantly different than the actual transfer price. The results of the validation exercise will therefore indicate the customs' values likely to be acceptable to the customs' authority under each method. The alternative methods must be applied in strict hierarchical order, except that the importer has the option of choosing the computed (i.e. cost plus) or deductive (i.e. resale-minus) method of valuation and is free to choose the method that yields the lower customs' value.

Transfer price exceeds acceptable customs value

If the application of the validation methods demonstrates that the transfer price is higher than the value that could be justified for customs' purposes, the taxpayer has the following options:

- Consider the scope for unbundling the transfer prices.
- Modify the transfer pricing policy.
- Submit valuation on the basis of an alternative method.

The transfer price may exceed the acceptable customs' value of the imported goods because it includes elements of cost and payments that need not be included in the customs' value. An exercise to 'unbundle' the transfer price and to separate those elements may result in a customs' value that is significantly less than the transfer price. Most jurisdictions have no legislative requirement to reconcile the value of imported goods for customs' purposes with the inventory value of those goods for corporate income-tax' purposes. Where such a requirement does exist, however – notably in the US – due account can be taken of those elements that form part of the inventory value but are not required to be included in the value for customs' purposes. If the unbundled transfer price still exceeds the acceptable customs' value, the taxpayer should consider

whether the transfer price does in fact meet the requirements of the revenue authority in the country of importation.

Corporate income tax is levied only on the profits of a transaction, whereas customs' duties are paid on its full value, irrespective of whether a profit or loss is made. In certain circumstances, notably where there are losses, a high transfer price – even if it is acceptable to the revenue authorities – may result in a net increase, rather than a reduction, in the overall tax burden when the increased duty liability is taken into account.

Customs' authorities do not normally entertain the argument that a transaction value is unacceptable solely because it has been inflated as a result of the relationship between the buyer and seller of the goods. It may be, however, that the circumstances surrounding the transactions between the buyer and seller are such as to preclude valuation on the basis of the transfer price, namely:

- The price is subject to some condition or consideration that cannot be quantified (e.g. the goods are supplied on consignment and the transfer price is dependent upon when, to whom and in what quantity the goods are resold).
- An unquantified part of the proceeds of the resale of the goods by the buyer accrues to the seller (other than in the form of dividends paid out of the net profits of the buyer's total business).
- The seller has imposed upon the buyer a restriction that affects the value of the goods in question (e.g. they can be resold only to a certain class of purchaser).
- The goods are supplied on hire or lease or on some other terms that do not constitute a sale of the goods (e.g. on a contingency basis).

Alternative methods of valuation

Once it is established that the imported goods cannot be valued for customs' purposes on the basis of the transaction value, the link between the transfer price for commercial and income-tax' purposes and the value of the goods for customs' purposes is broken. The taxpayer is then free to determine a transfer price without regard to the customs' implications, irrespective of whether the price so determined is higher or lower than the value of the goods for customs' purposes, except for countries like the US where the inventory value for tax purposes cannot exceed the customs' value. Several transfer pricing methods (TPMs) are available, many of which are sufficiently flexible to apply to a variety of transaction types. Traditional TPMs are the CUP method, the cost-plus method, and the resale price method. Other methods are the profit split and the transactional net margin methods.

The alternative methods of customs' valuation are similar to some of the methods used to validate transfer prices for income-tax' purposes, but the WTO Valuation Agreement requires that they be applied, with one exception, in strict hierarchical order as set out below:

1. **Value of identical goods.** The transaction value of identical merchandise sold for export to the same country of importation and exported at or about the same time as the goods being valued. The value of the identical merchandise must be a previously accepted customs' value, and the transaction must include identical goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued.

2. **Value of similar goods.** As in (1) except that the goods need not be identical to those being valued, although they must be commercially interchangeable.
3. **Deductive value.** A notional import value deduced from the price at which the goods are first resold after importation to an unrelated buyer. In arriving at the deductive value, the importer may deduct specific costs – such as duty and freight in the country of importation and either his/her commission or the profit and general expenses normally earned by importers in the country in question – of goods of the same class or kind.
4. **Computed value.** A notional import value computed by adding to the total cost of producing the imported goods, the profit and general expenses usually added by manufacturers in the same country of goods of the same class or kind. Note that, as an exception to the hierarchical rule and at the option of the importer, the computed valuation method can be used in preference to the deductive valuation method.

The valuation of identical or similar merchandise is similar to the CUP method. The CUP method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted. While simple on its face, the method is difficult to apply. The fact that any minor change in the circumstances of trade (e.g. billing period, amount of goods traded, marking/branding) may have a significant effect on the price makes it exceedingly difficult to find a transaction that is sufficiently comparable.

The deductive value method is similar to the resale price (RP) method. The RP method determines price by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross markup from the sale price to an unrelated third party, with the appropriate gross margin being determined by examining the conditions under which the goods/services are sold, and comparing the said transaction to other third-party transactions. Consequently, depending on the data available, either the cost-plus (CP) or the RP method will be most the appropriate method to apply.

The computed value method is similar to the cost plus (CP method. The CP method is determined by adding an appropriate markup to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with the appropriate markup being based on the profits of other companies comparable to the parties to the transaction. Amounts may be added for the cost of materials, labour, manufacturing, transportation, etc. Given the variables required for the proper application of this method, it is most appropriately used for the valuation of finished goods. As a matter of practice, some customs administrations do not accept the use of this method by importers given that the accounting for costs occurs in the country of export, which makes verification by local authorities difficult.

If it proves impossible to find a value under any of the above methods, a value must be found using any reasonable method that is compatible with the WTO Valuation Agreement and is not specifically proscribed. In practice, customs authorities often adopt a flexible application of the transaction value rules or one of the alternative methods in order to arrive at an acceptable value.

Implementation of the customs' pricing policy

The procedures for declaring the value of imported goods to customs' authorities vary from country to country. In most cases, however, some form of declaration as to the value of the goods is required at importation and the importer may be required to state whether the seller of the goods is a related party and, if so, whether the relationship has influenced the price.

In some cases – such as where identical goods are sold to an independent buyer in the same country of importation at the same price – the importer can declare the transfer price with any necessary adjustments as the value for customs' purposes. In most cases, however, the position is less clear and, where the local rules permit, the importer is strongly advised to seek a definitive ruling in advance from the customs' authority or, at least, to obtain the authority's opinion as to the validity of the values that it intends to declare.

Strictly speaking, the WTO Valuation Agreement places the onus on the customs' authority to prove that a price has been influenced by a relationship between the parties. In practice, however, the importer would be well advised – even if it is not intended to seek an advance ruling or opinion – to validate transfer prices for customs purposes and to maintain the necessary records, calculations and documentation for use in the event of a customs' audit or enquiry.

Transfers of intangibles

Intangibles per se are not subject to import duty, but when supplied as part of a package of goods and services, the value of intangibles may constitute part of the customs' value of the imports. When a package of goods and services is supplied for a single, bundled price, customs' duty is paid on that price in full, unless it contains any elements of cost that can be separately quantified and is permitted to be deducted from the price. As explained previously, it is up to the importer and the foreign supplier to unbundle the price so as to separately quantify and invoice the value of those costs that do not have to be added to the customs' value of imported goods if they are not already included. However, the following categories of intangibles are, subject to certain conditions, required to be included in the customs' value of imported goods:

- Payments by the importer, in the form of royalties or licence fees, for the use of trademarks, designs, patents, technology and similar rights, provided that the rights in question relate to the imported goods and that the payment therefore is a condition of the sale of the goods by the seller to the buyer.
- Intangible 'assists', except where the work is undertaken in the country of importation.
- Payments for computer software (subject to the options described in the GATT decision of 24 September1984).
- Payments for the right to resell or distribute imported goods (but excluding a voluntary payment by the buyer to acquire an exclusive right to resell or distribute the imported goods in a particular territory).
- Design, development, engineering and similar costs that represent part of the cost of manufacturing or producing the imported goods.

Royalties and licence fees

This is the most complex area of customs' valuation and each case has to be examined carefully to determine whether a liability to import duty arises. The following guidelines are helpful:

1. The key consideration in determining whether a royalty or licence fee is dutiable is the nature of the rights for which the payment is made. The basis on which the payment is calculated is usually not relevant.
2. Generally, if the imported goods are resold in the same state in which they are imported, any royalties or licence fees payable as a condition of the importation of those goods are likely to be dutiable. For example, if imported goods are resold under the manufacturer's trademark – whether it is affixed to the goods before or after importation – the corresponding royalty payment is dutiable, even if the payment is based on income from sale of the goods in the country of importation.
3. However, where goods are subjected, after importation, to substantial processing or are incorporated into other goods, such that the resulting product does not have the characteristics of the imported goods, it is likely that the royalty or licence fee is not considered to relate to the imported goods, provided that the rights in question relate to the finished product. An example of this would be where the rights conferred on the buyer enable him to manufacture a product using the seller's technology, patents or know-how or to sell that product under the seller's trademark. In such circumstances, it is unlikely that the royalty payments would be regarded as part of the customs' value of raw materials or components imported by the buyer from the seller for incorporation in the finished product. It may be necessary, however, to include at least part of the royalty in the customs' value of the imported components if those components contain the essential characteristics of the finished product (*see point [4] below*).
4. Difficulties frequently arise where the imported materials or components are considered by the customs' authority to contain the essential characteristics of the finished product. For example, the buyer may be paying a royalty for technology that supposedly relates to the manufacture of the finished product in the country of importation. However, if the process of manufacture is, in reality, no more than a simple assembly operation, customs may take the view that the technology is incorporated in the imported components rather than the manufacturing operation and deem the royalty to be dutiable. Another example is where the seller's particular expertise or specialty is clearly incorporated in one key component, which is imported. As a result, royalties paid for a company's unique technology which is incorporated in a single imported semiconductor device could be deemed dutiable even if the whole of the rest of the system is manufactured in the country of importation from locally sourced parts.
5. In circumstances where an importer is manufacturing some products locally using the affiliate's designs, know-how and materials or components, while importing others as finished items from the same or another affiliate, care must be taken to distinguish the rights and royalties applicable to each. In such cases, it would normally be expected that the seller would recover all its research, development and design costs in the price of the products that it manufactures and exports to the buyer; it is inappropriate therefore to charge royalties for those products.
6. The decision of whether royalty and licence fees are dutiable may be subject to varying interpretations in different countries. Some countries, for example, may consider periodic lump-sum licensing fees to be non-dutiable charges, provided that payments are not directly related to specific importations.

7. Cost-sharing agreements (i.e. for R&D) can prove problematic if adequate documentation is not maintained, establishing what portion of development costs relates to the import of products. In such instances, the local import authorities may take the position that all such costs in a general pooling of costs are considered dutiable.

In the case of the products manufactured in the country of importation, however, a royalty or licence fee is the only way in which the owner of the intangible can recover its costs. However, if a royalty refers to 'the right to manufacture and distribute the company's products in the territory', it will be deemed to relate to the imported products as well as those manufactured in the country of export. Alternative wording – "the right to manufacture the company's products in country A and to sell such products as it manufactures in the territory" – may avoid unnecessary liability to duty. Payments for the right to reproduce imported goods in the country of importation are specifically excluded from the customs' value of imported goods.

Intangible assists

Intangible assists consist of designs, specifications and engineering information supplied by the buyer of the imported goods to the seller free of charge or at reduced cost. If the work is undertaken within the country of importation, such assists are not dutiable, but if the work is undertaken in the country in which the goods are manufactured or in any other country, the assists are deemed to be part of the customs' value of the imported goods.

There are different interpretations of what is meant by the word 'undertaken'. Some customs authorities accept, for example, that work undertaken by the buyer's designers who are based in the country of importation but who actually designed the product in the country of manufacture would not result in a dutiable assist; others, however, would take the opposite view. However, even if work is performed in the country of importation but paid for by the foreign seller and recharged to the importer, it may constitute a dutiable cost as representing part of the price paid or payable for the imported product. The value of an assist is the cost to the buyer of producing or acquiring it, and it is not necessary to add a markup or handling fee.

Interest

Interest incurred by the manufacturer of imported goods is deemed to be part of the cost of producing the goods and should therefore be included in the price. However, where the importer pays interest – to the seller or a third party – under a financing agreement related to the purchase of the imported goods, that interest need not be included in or added to the customs' value of imported goods, provided that:

- The financing agreement is in writing (although this need only be a clause in the agreement for the sale of the goods).
- The rate of interest is consistent with contemporary commercial rates of interest for such transactions in the country in which the agreement is made.
- The buyer has a genuine option to pay for the goods promptly and thereby avoid incurring the interest charge.
- The interest is separately invoiced or shown as a separate amount on the invoice for the goods.
- In some countries, such as the US, the interest must be treated as an interest expense on the books and records of the importer.

Computer software
Contracting parties to the WTO Valuation Agreement may value software for use with data processing equipment on one of two alternative bases, namely:

1. The full value of the software, including the carrier medium (disk, tape, etc.) and the program data or instructions recorded thereon.
2. The value of the carrier medium only.

The second option applies only to software in the form of magnetic tapes, disks and similar media. Software on the hard disk within a computer or embedded in semiconductor devices (firmware) is dutiable on the full value. Similarly, this option does not extend to software that includes audio or visual material. Although this exclusion was originally intended to cover leisure products, such as computer games, movies and music, more and more serious software now incorporates audio and visual material and, in some jurisdictions, may be subject to duty on the full value.

The terms of the present valuation options on software dated from 1985 have been overtaken by advances in technology and commercial practice in the data processing industry. Furthermore, the Information Technology Agreement (ITA) has resulted in most movements of computer software becoming subject to a zero rate of duty. It is inevitable therefore that importers will face anomalies and uncertainties in the valuation of software unless or until the WTO Valuation Agreement is updated to reflect these developments. However, it is worth noting that software and other goods transmitted electronically do not attract customs duty even if, in their physical manifestation, they would be dutiable (e.g. music CDs, videos).

Design, development, engineering and similar charges
The costs of these activities are normally expected to be included in the price paid for the imported goods. However, there are circumstances in which companies may wish to recover these costs from their affiliates by way of a separate charge. Furthermore, the affiliate may be supplied not with finished products but only with components on which it is not normal to seek to recover such costs.

Generally speaking, any payment for design and similar expenses that relates to imported goods is regarded as part of the customs' value of those goods and an appropriate apportionment will be made and added to the price of the goods. Costs for research, if properly documented as such, are not subject to duty.

Where components are supplied to the buyer and a separate charge is made relating to the design of the finished product that is manufactured in the country of importation, some difficulty may arise. If the components are purchased by the seller from third-party suppliers, the costs of design are likely to be included in the supplier's price and no further action is necessary. However, where some or all of the components are produced by the seller and design costs have not been included in the price, it will be necessary to attempt to allocate an appropriate proportion of the total charge for design to the components in question.

The impact of transfer pricing policy changes
Where the basis of customs' valuation is the transaction value – the price actually paid or to be paid for the imported goods – any change in the method of determining the transfer price may affect the validity of that price for customs' purposes. It may also

trigger a requirement to notify the customs authority if the buyer holds a ruling that is subject to cancellation or review in the event of a change in commercial circumstances.

If the proposed change in pricing arrangements is significant, the validation exercise described previously must be repeated to determine whether the new policy produces an acceptable value for duty purposes. Examples of significant changes are:

- A shift in the allocation of profit from one entity to another.
- A shift of responsibility for certain functions from one entity to another.
- A change in the transaction structure, such as the interposition or removal of an export company, a foreign sales corporation or a reinvoicing centre.
- Any changes in pricing levels that exceed normal commercial margins of fluctuation.

Provided that the changes represent realistic responses to changes in commercial circumstances, there should be no difficulty in validating the new prices for customs' valuation purposes. However, where no such justification for the changes exists – and particularly where the price change is substantial – it may be difficult to explain satisfactorily why the prices now being proposed have not previously been charged since the commercial circumstances are substantially unchanged.

If the proposal is to increase prices, the customs authority may take the view that the values previously declared, based on the current transfer pricing policy, were too low and, depending upon local regulations, they may be able to recover substantial arrears of duty and to impose penalties. Conversely, even if the customs authority accepts that the current transfer prices are higher than commercial circumstances justify, there will probably be no basis for claiming repayment of duties overpaid, even if the seller credits the buyer with the difference between the existing and proposed prices on a historical basis.

The impact of retrospective transfer price adjustments

The WTO Valuation Agreement contains no specific provisions for dealing with adjustments to transaction values and, therefore, the rules and practice in each country determine how customs authorities respond if a price already paid is subject to subsequent adjustment for commercial or corporation tax' purposes.

The transaction value principle states that the price for the goods 'when sold for export to the country of importation' should represent the customs' value of those goods. Provided, therefore, that the price paid or agreed to be paid at that time was not in any way provisional or subject to review or adjustment in the light of future events, specified or otherwise, that price must be the customs' value of the goods. If, subsequently, that price is adjusted as a result of circumstances that were not foreseen at the time of the sale for export – or that, if they had been foreseen, were not expected or intended to lead to a price adjustment – there appears to be no provision under the WTO Valuation Agreement that would either:

- in the event of a downward adjustment, allow the importer to recover duty overpaid, or
- in the event of an upward adjustment, allow the customs authority to recover duty underpaid.

However, it is likely that, so far as customs authorities are concerned, the above is true only of occasional and non-recurring adjustments. If, for example, a company were to make a practice of reviewing its results at the end of each fiscal year and decided to reallocate profit between itself and its affiliates, it is probable that customs would take the view that such adjustments were effectively part of the company's transfer pricing policy, even if no reference to it appeared in any written description of that policy. In those circumstances, subject to any statute of limitations, they would be likely to seek arrears of duty and possibly also penalties for all previous years in which upward adjustments had been made. While some customs jurisdictions may give credit for any downward adjustments in assessing the amount of duty due, it is unlikely that they would accept a claim for repayment where a net overdeclaration of value could be substantial.

Where a company's transfer pricing policy specifically provides for periodic review and retrospective price adjustment – for example, to meet the requirements of the IRS and other revenue authorities – customs will certainly regard any adjustments as directly applicable to the values declared at the time of importation. Any upward adjustments will therefore have to be declared and the additional duty paid. Downward adjustment, in some countries, may be considered post-importation rebates and consequently claims for overpaid duties will not be accepted. However, in the US, importers may take advantage of the Custom's Reconciliation Program, which provides the opportunity to routinely adjust the value of imported goods and either collect or pay duties.

In addition, in the US, a specific IRS provision (1059A) requires that the inventory basis for tax purposes does not exceed the customs' value (plus certain allowable adjustments). Therefore, the possibility exists that the IRS authorities could disallow any upward price adjustment in the event it causes the inventory taxable basis to exceed the customs' value. To avoid penalties for failing to declare the full value of imported goods and to ensure that duty can be recovered in the event of price reductions, it is recommended that any transfer pricing policy that involves retrospective price adjustments should be notified to customs in advance. Some authorities are amenable to arrangements whereby provisional values are declared at the time of importation and subsequent adjustments are reported on a periodic basis, provided they are accompanied by the appropriate additional duties or claims for repayment.

As an alternative to the above, it may in some cases be in the importer's interests to take the position that, at the time of importation, there is no transaction value because the eventual price for the goods cannot then be determined. In that event, the importer could seek valuation under one of the alternative methods described above.

The impact of international structure

The structure of a transaction chain that involves at least one cross-border movement between different customs' jurisdictions can have a significant impact on duty liabilities. Transaction values exist only where there is a price for imported goods between two separate legal entities in a sale whereby ownership of the goods and the attendant risks pass from the seller to the buyer. In the absence of such a sales price between the exporter and importer, the customs' value must be based on another sales' transaction, if there is one, or on one of the alternative methods of valuation described above. The following examples illustrate the impact of various structures on the value of imported goods for duty purposes:

- Where an exporter uses a subsidiary company in the country of importation as its distributor, and the latter buys imported goods as a principal and resells them to end-customers, the price between the two companies is, in principle, acceptable for customs' purposes. However, this is not the case where the distributor is merely a branch of the exporter and part of the same legal entity. In that event, unless there is another transaction value, duty is payable on the selling price to the end-customer, including the gross margin of the branch.
- Similarly, there is no transaction value if the subsidiary merely acts as a selling agent or commissionaire for the exporter and does not own the imported goods. Again, duty is payable on the selling price to the end-customer, including, in this case, the subsidiary's commission.
- Transactions involving reinvoicing operations that merely issue a new invoice in a different currency and do not take title or risk in respect of the imported goods are ignored for customs' purposes, as are those involving foreign sales corporations (FSCs), which are remunerated by way of commission. However, transactions involving FSCs that act as principals may provide a basis of valuation.

The customs laws of the EU and the US (but not, at present, any other jurisdiction) recognise a transaction value, based on a sale for export to the country of import even when there are subsequent sales in the supply chain (successive or first sale concept). This means, for example, that if a manufacturer in the US sells goods for 80 United States Dollars (USD) to a US exporter who, in turn, sells them to an importer in the EU for USD 100, the latter can declare a value of USD 80 for duty purposes, even though USD 100 was paid for the goods. Acceptance of the price in the earlier sale is conditional upon the following factors:

- The goods being clearly intended for export to the country of importation at the time of the earlier sale.
- The price being the total consideration for the goods in the earlier sale and not being influenced by any relationship between the buyer and seller.
- The goods being in the same physical condition at the time of the earlier sale and at importation.

Apart from allowing duty legitimately to be paid on what is, in most cases, a lower value, the 'successive sales' concept in the EU and 'first sale' approach in the US also have the benefit of decoupling the value of imported goods for duty purposes from the values of those goods for the purposes of determining the taxable profits of the importer and exporter. Japan also provides for duty reduction based on a principle very similar to that which underlies the 'first sale' programmes in the US and EU, albeit in a more complex manner.

Dealing with an audit of pricing by an indirect tax authority

For similar reasons to those advanced by the tax authorities, customs authorities are taking an increasing interest in the validity of values declared by importers on the basis of transfer prices between related parties. The principal areas on which they focus their inquiries are:

- Whether the transfer price allows full recovery of all relevant costs, including general and administrative overheads and relevant R&D.
- Whether the addition for profit occurs on an arm's-length basis.
- Whether all appropriate additions have been made for royalties, R&D payments and assists.

Transfer pricing and indirect taxes

Traditionally, customs authorities have tended to operate in a vacuum, with no consideration for the commercial or tax environments within which transfer pricing policies are developed and implemented. This has led to considerable frustration as companies have tried to defend to customs' officers prices that are not only commercially justifiable but have already been accepted by the revenue authorities. However, this situation is changing in some jurisdictions where customs authorities are making efforts to understand the OECD Guidelines and are increasingly interfacing and cooperating with their direct-tax revenue colleagues. It is unlikely that greater knowledge and understanding will lead to fewer customs valuation audits – indeed, the opposite is more likely to be the case – but it should mean that they are less troublesome for importers.

As for tax purposes, the availability of documentation that describes the company's overall transfer pricing policy and demonstrates how individual transaction values have been calculated is essential. In addition, a similar approach to customs' value documentation should also be undertaken. This can start with the transfer pricing documentation and include the appropriate additional analysis required by customs. In addition, where the position is complex and there is likely to be any contention as to the correct values, it is strongly recommended that the facts and legal arguments be presented to the customs authority before the relevant imports commence and, as advisable, a formal ruling or opinion obtained. Although these will not preclude subsequent audit, the latter should then be confined to verification of the relevant facts rather than involve arguments about issues of principle.

Strategy based on balance and leverage

A prudent company will take the same care and documentation approach for customs as it does for transfer pricing. Considering the above, it can be argued that an importer's sole reliance on a transfer pricing analysis would likely not be sufficient to support the proper appraisement of merchandise for customs' valuation purposes. To believe and act otherwise runs the risk of being subjected to fines, penalties or a mandated application of an alternative customs' valuation method that may be difficult and costly to implement and sustain. Indeed, the belief that if a taxpayer has done a transfer pricing study then its customs' value must be correct has been proven wrong time and time again.

Still, a transfer pricing analysis and related documentation can be leveraged to provide a basis from which a customs' value may be derived and supported. This assumes, of course, that all required statutory adjustments are applied and other relevant considerations are factored in. The potential benefits to global traders from finding an appropriate balance in the transfer pricing and customs' valuation nexus are many and include the following:

- A foundation for establishing inter-company pricing policies for customs' purposes that help to decrease accounting issues that are created by gaps, lack of coverage, or contradictions among inter-company pricing initiatives.
- The ability to significantly reduce the potential of a customs' audit as well as the financial exposure related to penalties associated with non-compliance of customs' regulations.
- A global (or at least multijurisdictional), long-term coordinated inter-company customs' valuation documentation compliance solution that considers products/ product line, market conditions, and other key economic factors.

- A basis for proactively managing value adjustments to achieve arm's-length results required under tax and customs' regulations.
- A foundation for pursuit of advanced pricing agreements that may also be considered by customs authorities as evidence of an appropriate arm's-length result.
- The ability to identify planning opportunities related to the valuation of merchandise and intangibles (e.g. royalties, licence fees, research and development, warranties, marketing and advertising, cost-sharing arrangement) via alternative methods of appraisement.
- The development of limits to customs authorities' ability to interpret Art. 1.2(a) and (b) of the WTO Customs Valuation Agreement relating to the acceptability of using the transfer price as an initial basis for the customs' value of imported merchandise.
- Enhanced financial reporting compliance related to inter-company cross-border transactions to satisfy obligations under Sarbanes-Oxley reporting requirements.

Transfer pricing and indirect taxes

10.

Procedures for achieving an offsetting adjustment

Introduction

Early consideration should be given to the procedures that might be followed to obtain compensating adjustments in other jurisdictions should a transfer pricing audit lead to additional tax liabilities in a particular jurisdiction. The attitudes of revenue authorities vary and will depend upon the overall circumstances (such as whether they consider that the taxpayer has deliberately sought to reduce their taxes by what they perceive to be ‘abusive’ transfer pricing).

Generally, no scope is available with which to make adjustments in the absence of a double tax treaty or multi-country convention. However, it might be possible to render further invoices in later years reflecting pricing adjustments, although these types of adjustments are frowned upon and attract scrutiny from the tax authority of the receiving jurisdiction. Very careful attention needs to be paid to the legal position of the company accepting retroactive charges and to other possible consequences, particularly to indirect taxes. Nevertheless, in a few cases this may afford relief.

The ability to seek relief under the mutual agreement procedure process and, more particularly, under the European Union Convention, which is discussed in this chapter, is sometimes cited by taxpayers as if it is an easy solution to transfer pricing problems. This is not the case and should certainly not be viewed as allowing taxpayers to avoid paying careful attention to the implementation of a coherent transfer pricing policy and to its defence on audit.

Competent authority

Competent authority procedures for the relief of double taxation are typically established in bilateral tax treaties and must always be considered when a tax authority proposes an adjustment to prices. For instance, where a US subsidiary accepts that the price of each widget sold to it by its UK parent should be reduced by, say, 10 British pounds (GBP), to satisfy the US Internal Revenue Service, will the UK Inland Revenue accept a corresponding reduction in UK taxable income? This type of question involves consultation with the competent authorities. Virtually all double tax treaties contain provisions similar to those set out in Article 25 of the OECD Model. These provide that a taxpayer may petition the competent authority of the state in which he/she is resident where the actions of one or both of the treaty partners “… result or will result for him/her in taxation not in accordance with the provisions of [the double tax treaty]”.

In the course of an audit, a taxpayer needs to consider whether reference should be made to the competent authority procedures and at what stage. It is necessary to pay attention to the required procedures and, more particularly, to the statute of limitations under each treaty. Adjustments may not be possible after a tax liability has become final, and only if the other revenue authority is prepared to give relief will double taxation then be avoided. While in general, revenue authorities consider that their enquiry should have been concluded before they begin discussions with the other

revenue authority, they may be prepared to delay the finalisation of any assessment and, in particularly complex cases, may be willing to operate the procedure in parallel with the conduct of their audit. However lengthy or uncertain they are, the competent authority procedures remain the main process through which a taxpayer can hope to avoid double taxation after paying tax in respect of a transfer pricing adjustment.

It is significant to note that the Mutual Agreement Procedure under a double tax treaty ordinarily provides an alternative process of dispute resolution and is an option available to the taxpayer in addition to and concurrently with the prevailing appellate procedures under domestic law. The reference to the competent authority is to be made by the aggrieved party impacted by taxation not in accordance with the treaty. Consequently, the reference would be made by the taxpayer, which has or may suffer double taxation arising from the adjustment to the transfer price of an associated enterprise, rather than the enterprise itself.

Further, it is important to recognise that the charter of the mutual agreement procedure process is to mitigate taxation not in accordance with the treaty and not a means of eliminating the tax impact of a proposed transfer pricing adjustment. The mutual agreement procedure is a negotiation process between the competent authorities and ordinarily involves a compromise on both sides, by way of reaching a consensus on the acceptable transfer prices. During the mutual agreement procedure process, it is advisable for the taxpayer and its associated enterprise to provide inputs to respective competent authorities on an ongoing basis so that an effective and acceptable settlement is expeditiously reached. The taxpayer is at liberty to accept the agreement reached by the competent authorities or decline the arrangement (and by consequence revert to remedies under domestic law). The taxpayer may also withdraw its reference to the competent authorities during the negotiation process.

European Union arbitration convention

Background

On 23 July 1990, the representatives of Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and the UK jointly approved a convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (Convention 90/436). This multilateral convention represented a unique attempt to solve some of the difficulties faced by multinational enterprises in the transfer pricing area.

There were a number of procedural difficulties that made its use difficult, due to the modifications required to ratify the original treaty, to reflect the accession of Finland, Sweden and Austria, and also to the ratifications needed to extend the life of the original treaty beyond 31 December 1999. These procedural difficulties have now been overcome, thanks to the work of the EU Joint Transfer Pricing Forum. In November 2006, the Council Convention was amended with the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and the Slovak Republic in the European Union and entered into force on 1 November 2006.

The scope of the Convention

The Convention is designed to apply in all situations in which profits subject to tax in one Member State are also subject to tax in another as a result of an adjustment to correct non-arm’s-length pricing arrangements. The Convention also provides that relief is available under its terms where there is a risk of losses being doubly

disallowed. However, the Convention is not applicable in any circumstance in which the authorities consider that the double taxation arises through deliberate manipulation of transfer prices. Such a situation arises in any instance where a revenue authority is permitted to levy a 'serious penalty' on the business concerned. This is considered in more detail below (*see The advisory commission*).

The businesses that can benefit from the Convention are those that constitute 'an enterprise of a contracting state'; this specifically includes permanent establishments of any enterprise of a contracting state. No further definition of these terms is included in the Convention, although it is stipulated that, unless the context otherwise requires, the meanings follow those laid down under the double taxation conventions between the states concerned. The intention was undoubtedly that all businesses of any description which have their home base within the European Union (EU) should receive the protection of the Convention, regardless of their legal form. Consequently, a French branch of a German company selling goods to an Italian affiliate would be covered. However, a French branch of a US company selling goods to an Italian affiliate would not be covered. It is important to note that the Convention is drawn up in terms that recognise not just corporations but also other forms of business, subject to tax on profits.

The required level of control

In drafting the Convention on transfer pricing, the European Commission recognised that Member States use widely varying definitions of the level of control required between affiliated businesses before anti-avoidance law on transfer pricing can apply. The Convention's definition of control for these purposes is accordingly very widely drawn indeed. It merely requires that one Member State enterprise "participates directly or indirectly in the management, control or capital of an enterprise of another contracting state" and that conditions are made or imposed between the two enterprises concerned such that their commercial and financial relationships differ from those that would have been made between independent enterprises. A similar definition deals with the situation where two or more Member State businesses are controlled by the same person.

Regarding the profits to be attributed to a permanent establishment, the Convention follows the OECD Model Treaty, requiring that the permanent establishment be taxed on profits that it might be expected to make if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

Adjustments to profits

The Convention makes no attempt to interfere with the processes by which the tax authorities of any one Member State seek to make adjustments to the profits declared by a business operating in their country. However, where a contracting Member State does intend to make an adjustment on transfer pricing grounds, it is required to notify the company of its intended actions in order that the other party to the transaction can give notice to the other contracting state. Unfortunately, there is no barrier to the tax adjustment being made at that stage. As a result, Member State businesses still face the cash-flow problems associated with double taxation until such time as the authorities agree to make offsetting adjustments. If this double taxation cannot be eliminated by agreement between the two countries concerned, then the remaining provisions

of the Convention may be used to gain relief. To address these issues, the Council of the European Union adopted a Code of Conduct for the effective implementation of the Convention wherein it has recommended Member States to take all necessary measures to ensure that tax collection is suspended during the cross-border dispute resolution procedures under the Arbitration Convention. As of September 2006, 16 Member States had allowed the suspension of tax collection during the dispute resolution procedure and other states were preparing revised texts granting this possibility.

Mutual agreement and arbitration procedures

The Convention provides for an additional level of protection to Member State businesses over and above anything available under the domestic laws of the states concerned or through the existing bilateral treaties. The protection available begins with the presentation of a case to the competent authority of the contracting state involved. This presentation must take place within three years of the first notification of the possible double taxation. The procedures require that all the relevant competent authorities are notified without delay and the process is then underway to resolve the problem, regardless of any statutory time limits prescribed by domestic laws.

If the competent authorities are unable to reach an agreement within two years of the case first being referred to them, they are obliged to establish an advisory commission to examine the issue. The Convention provides that existing national procedures for judicial proceedings can continue at the same time as the advisory committee meets, and that if there is any conflict between the procedures of the arbitration committee and the judicial procedures in any particular Member State, then the Convention procedures apply only after all the others have failed.

Serious penalty proceedings

There is no obligation on Member States to establish an arbitration commission to consider pricing disputes if "legal and administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of transfers of profits … one of the enterprises concerned is liable to a serious penalty". Where any proceedings are currently underway, which might give rise to serious penalties, the normal due date for the establishment of the arbitration committee is deferred until the other proceedings are settled.

The term 'serious penalty' is somewhat subjective and has different meanings from one country to another. However, the Member States have included, as part of the treaty, unilateral declarations on their view of the meaning of 'serious penalty' for these purposes.

The advisory commission

When an advisory commission is needed, it is established under the chairmanship of an individual possessing the qualifications required for the highest judicial offices of his/her country. The other members of the commission include a maximum of two individuals from each of the competent authorities involved and an even number of independent persons of standing, to be selected from a list of such people drawn up for the purpose by each contracting state. The task of the advisory commission is to determine, within six months, whether there has been a manipulation of profits, and, if so, by how much. The commission makes its decisions by simple majority of its members, although the competent authorities concerned can agree together to set up

the particular detailed rules of procedure for any one commission. The costs of the advisory commission procedure are to be divided equally between all the contracting states involved.

In reaching its decision, the advisory commission may use any information, evidence or documents received from the associated enterprises concerned in the transactions. The commission can also ask the competent authorities of the contracting states involved to provide it with anything else it requires, but there is no obligation on the contracting states to do anything that is at variance with domestic law or normal administrative practice. Furthermore, there is no obligation on them to supply information that would disclose any trade secret, etc. which might be contrary to public policy. There are full rights of representation for the associated enterprises involved to speak before the advisory commission.

Resolution of the problem

Once the advisory commission has reported, the competent authorities involved must take steps to eliminate the double taxation within six months. They retain the discretion to resolve matters as they see fit, but if they cannot agree on the necessary steps to be taken, they must abide by the decision of the advisory commission.

Term of the convention

The Convention came into force on 1 January 1995 for an initial period of five years. However, it was agreed in May 1998 that the Convention would be extended for at least a further five-year period. During this time Austria, Finland and Sweden joined the EU and became parties to the Convention. The original protocol for accession of new Member States required that all parties had to satisfy each accession, and consequently extensions to membership required lengthy procedures to ensure the continued life of the Convention. As a result of the work with the EU Joint Transfer Pricing Forum, it is anticipated that as new countries join the EU they will accede to the Arbitration Convention by a simpler process.

Interaction with non-member states

The Convention recognises that countries other than the Member States of the EU may be involved in transfer pricing disputes with EU businesses. The Convention simply notes that Member States may be under wider obligations than those listed in the Convention and that the Convention in no way restricts these obligations. There is no comment on the way in which third-country disputes might be resolved.

Experience of the Convention

While the Convention is already perceived by the EU members as being a major step forward in the development of worldwide tax policies designed to resolve pricing issues, there is little practical experience of its use (the first ever advisory commission set up under the Convention only met on 26 November 2002 to begin looking at a Franco–Italian matter). It is understood that there is now a backlog of more than 100 cases that might go to arbitration, following the resolution of the procedural problems faced by the Arbitration Convention. The EU Joint Transfer Pricing Forum will monitor the work to make sure matters are followed through on a timely basis.

Further EU developments in transfer pricing

Within Europe, the EU Commission struggled for many years to attain agreement on a common tax base for European businesses or common tax rates across the EU states. This is politically highly difficult to achieve and there remains little likelihood of substantial agreement in this area in the foreseeable future. However, the Commission convinced Member States that there was no political logic in favour of continuing the problems experienced by multinationals when they faced double taxation as a result of transfer pricing adjustments being made by tax authorities. The Arbitration Convention represents the statement that, from a purely pragmatic point of view, it must be reasonable to eliminate such double taxation of profits.

The European Commission would like to go much further. Instead of rectifying double taxation after it has occurred, the Commission would like to see a mechanism for preventing it in the first place. A number of Commission officials have stated their wish to see possible transfer pricing adjustments being discussed among the competent authorities before they are made, such that any offsetting adjustment could be processed at the same time as the originating adjustment. Some Commission officials want to go even further than this and create a regime for multilateral advance pricing agreements on pricing issues within the EU.

It is clear that the European authorities firmly support the use of the arm's-length principle in transfer pricing. They are on record, via the Convention, as stating that they do not approve of double taxation. Most of the Member State tax authorities have privately expressed the view that, however desirable, advance pricing agreements represent an unacceptably high administrative burden. Information on the use of the Convention within Europe has been lacking. However, this was remedied in October 2001 when a Commission working paper published a summary for 1995 to 1999. During this period, 127 intra-EU transfer pricing cases were referred to the Arbitration Convention or to a bilateral treaty mutual agreement procedure (it is interesting to note the total number of cases rises to 413 when non-EU country counterparties are brought in). The paper estimated that 85% of the cases had been satisfactorily resolved, removing double taxation in an average timescale of 20 months. In its recent communication in February 2007, the European Commission revealed that none of the 24 cases for which the taxpayer had made the request for mutual agreement procedure prior to January 2000 was sent to arbitration commission.

Recognising that considerable numbers of transfer pricing cases are never referred to competent authorities for resolution, the Commission identified transfer pricing as a major concern for cross-border business. To review the tax position on transfer pricing in the EU and to consider pragmatic ways in which the burden on business could be relieved, in early 2002 the Commission proposed the establishment of the EU Joint Transfer Pricing Forum. This was a radical step, in that membership would include both government personnel and representatives from business. In addition to the chairperson, the forum now includes 25 Member State representatives and 10 business representatives (the author is one of the 10) together with Commission membership and observers from the OECD and EU accession states.

The forum's work resulted in two formal reports. The first was published on 27 April 2004 and was adopted by the ECOFIN Council on 7 December 2004. The material is available on the Commission websites and contains detailed guidance on the operation of the Arbitration Convention, including practical matters relevant to time limits

and the mutual agreement procedures. The Council adopted the Code of Conduct recommend by the EU Joint Transfer Pricing Forum in full.

The second report of the EU Joint Transfer Pricing Forum was completed in mid-2005 and set out a proposal for documentation standards across all Member States. The Commission adopted the proposal on 10 November 2005. In June 2006, the Council of the European Union adopted a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union. This Code of Conduct standardises the documentation that multinationals must provide to tax authorities on their pricing of cross-border, intragroup transactions.

Considering the recent achievements within the EU and the need to ensure a monitoring of implementation of codes of conduct and guidelines and the examination of several issues, the EU Joint Transfer Pricing Forum has been renewed for a new mandate of two years. The Commission has endorsed the Joint Transfer Pricing Forum's suggestions and conclusion on advance pricing agreements and on this basis released guidelines for advance pricing agreements in the EU. Going forward, the Joint Transfer Pricing Forum will continue to examine penalties and interest related to transfer pricing adjustments and focus on the important area of dispute avoidance and resolution.

International updates in cross-border dispute resolution

Taking a cue from the EU Arbitration Convention, OECD countries have agreed to broaden the mechanisms available to taxpayers involved in cross-border disputes over taxation matters by introducing the possibility of arbitration if other methods to resolve disagreements fail. The background for this initiative goes back to February 2006, when the OECD released a public discussion draft entitled *'Proposals for improving mechanisms for resolution of tax treaty disputes'*. This public discussion draft essentially dealt with the addition of an arbitration process to solve disagreements arising in the course of a mutual agreement procedure and the development of a proposed online manual for an effective mutual agreement procedure.

The OECD received numerous comments on the public discussion draft and followed it up with a public consultation meeting in March 2006. As a result of these comments and meeting, the Committee of Fiscal Affairs of the OECD approved a proposal to add to the OECD Model Convention an arbitration process to deal with unresolved issues that prevent competent authorities from reaching a mutual agreement.

The proposed new paragraph to the Mutual Agreement Procedure Article of the OECD Model Convention (paragraph 5 of article 25) provides that in the event the competent authorities are not able to reach agreement in relation to a case presented to the competent authority for resolution within a period of two years from the presentation of the case, it may be submitted to arbitration at the request of the taxpayer. It is left to the discretion of the member countries as to whether the open items may be submitted for arbitration if a decision on these issues is already rendered under domestic law.

Issues of treaty interpretation would be decided by arbitrators in the light of principles incorporated in the Vienna Convention on the Law of Treaties, whereas the OECD Guidelines would apply in respect of transfer pricing matters.

Procedures for achieving an offsetting adjustment

Finally, the OECD has recently developed a Manual on Effective Mutual Agreement Procedure explaining the various stages of the mutual agreement procedure, discussing various issues related to that procedure and, where appropriate, bringing out certain best practices.

11.

The OECD's BEPS Action Plan

Overview

With the concern over perceived tax avoidance and double non-taxation having reached the highest levels of governments, and with growing attention from the media and the public on international tax planning practices of high-profile multinationals, the Organisation for Economic Co-operation and Development (OECD), in conjunction with the G20 and developing nations around the world, has taken up the matter of Base Erosion and Profit Shifting (BEPS).

The OECD's Action Plan on BEPS was published in July 2013 with a view to addressing perceived flaws in international tax rules. The BEPS Action Plan, which was developed pursuant to a directive by the G20 nations, identified 15 key areas to be addressed by 2015; with seven deliverables delivered in September 2014. The 40 page Action Plan, which was negotiated and drafted with the active participation of its member states, contains these 15 separate action points or work streams organised by areas of perceived gaps in the international tax system some of which are further split into specific sub-actions or outputs. The Plan is squarely focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers at their summit in St. Petersburg in September 2013.

The work under the Action Plan has resulted in discussion drafts or final reports on all of the 15 workstreams. While seven deliverables were agreed and approved by the G20 finance ministers in September 2014, most of the proposed measures are not yet finalised, as they may be impacted by further deliverables. However, the guidelines implementing Transfer Pricing Documentation and Country-by-Country (CbC) Reporting are substantially completed, as are the recommendations on Hybrids, the study on the digital economy, and the mandate for a multilateral tax treaty.

Completion of most of the work for the 15 actions is scheduled to take place by December 2015, though the OECD announced in July 2015 that certain work including Use of Profit Split Methods, Financial Transactions, Profit Attribution to Permanent Establishments, and Implementation of Hard to Value Intangibles may not be finalised until 2016. While it may take longer for the impact of these changes to be fully applied in practice, the BEPS project and related developments are already leading to the need for business to take action (in some cases, urgent action) both to comply with new requirements and to consider the ways in which they do business in different countries. To the extent that the changes relate to the OECD's Model Tax Convention and Transfer Pricing Guidelines, their implementation is assured and should follow fairly quickly. The speed with which they are then implemented in existing bilateral tax treaties will be heavily linked with the success of the OECD's proposed 'multilateral instrument', which the OECD has reported can be applied without any obvious technical barriers (though practical issues may be of more concern). The proposed OECD rule changes that involve amendments being made by individual territories to domestic tax rules are likely to be widely but not universally adopted, though consistency and timing is uncertain.

Governments, revenue authorities and business will all have a material role to play over coming months if the proposed changes are to be effective.

Action 1: The digital economy

'Solving' the digital issue – specifically identifying appropriate tax rules to deal with digital business – has been designated the number-one action in the BEPS Action Plan.

While the final version of the report issued 16 September 2014 does not introduce any conclusions that the initial draft left unaddressed, it does bring greater clarity to issues that have given rise to the need for the digital economy workstream. The report also explains the role of the Digital Economy Task Force (DETF) for the remainder of the BEPS project.

The primary conclusion remains that the digital economy is so widespread that it pervades the global economy as a whole. In consequence, it is not possible to isolate it for purposes of creating separate tax rules.

Nonetheless, it is clear that, if the other BEPS workstreams do not address the specific concerns and challenges identified, the DETF has the remit to propose its own solutions. Indeed, in referring to the continual developments of how technological innovation affects business, the DETF implies that its work may need to survive the end of the BEPS process to deal with a recurrence of the issues which it identifies. It also notes issues which may come from but are currently unidentified: the Internet of Things[1]; virtual currencies; advanced robotics and 3D printing; the sharing economy; access to government data; and reinforced protection of personal data.

The report focuses on the fragmentation of international business models, aided by developments in technology, as being the key tax area to address, identifying the specific remedies to be considered by the other BEPS workstreams – specifically, controlled foreign company (CFC) rules; artificial avoidance of permanent establishment (PE); and transfer pricing measures.

A new suggestion in the report (which picks up on a request in the public consultation) is that Working party No. 1 of the Committee on Fiscal Affairs should consider the characterisation of various payments arising in the new information and communication technology-enabled world (a couple of examples are given in the report, namely Cloud computing and 3D printing).

Draft input to the International VAT/GST Guidelines, prompted in substantial part by the need to clarify VAT/GST application to digital transactions, was published in December 2014 in two parts providing:

- guidance on the place of taxation for B2C supplies of services and intangibles, and
- supporting provisions to facilitate proper and consistent implementation of the Guidelines' principles in national legislation, including consistent interpretation by tax administrations.

1 "The Internet of Things refers to the internet-enabled network of physical objects that can connect and interact with one another. Sensors, networks, objects, and even humans can produce data that is picked up by connected devices and converted into one or more of a diverse range of actions and impulses." http://www.worldinbeta.com/blog/internet-of-things-world-in-beta

Action 2: Hybrid mismatch arrangements

The OECD's second action point in the BEPS Action Plan is to "neutralise the effects of hybrid mismatch arrangements." On 19 March 2014, the OECD released two draft reports calling for the introduction of both domestic rules and amendments to the OECD Model Tax Convention. The draft reports describe 'hybrid mismatch arrangements' as being the result of a difference in the characterisation of an entity or arrangement under the laws of two or more tax jurisdictions that result in a mismatch in tax outcomes.

On 24 September 2014, the OECD issued a comprehensive set of recommendations regarding domestic rules and treaty provisions to address the cross-border tax effects of hybrid entities, instruments, and transactions.

The domestic law recommendations are identified and categorised within three types of hybrid mismatch arrangements, identified according to their tax effects. The two main types of mismatches identified are payments that (i) are deductible under the rules of the payer and not included in the income of the recipient (deduction/no inclusion or 'D/NI' outcomes) and (ii) give rise to duplicate deductions from the same expenditure (double deduction or 'DD' outcomes). The third type of mismatch is where non-hybrid payments from a third country can be set off against hybrid mismatch arrangement deductions and thus are not included in the income of the recipient (indirect deduction/no inclusion or 'indirect D/NI' outcomes). Within these three categories of hybrid mismatch arrangements are the different types of hybrid transactions and entities specifically addressed by the deliverable.

D/NI outcomes include (i) hybrid financial instruments (including transfers), covering deductible payments made under a financial instrument that is not taxed as ordinary income in the payee's jurisdiction; (ii) disregarded hybrid entity payments, covering deductible payments that are not taxed as ordinary income in the payee's jurisdiction; and (iii) payments made to reverse hybrids, covering payments made by an intermediary payee where differences in characterisation of the intermediary entity by its own jurisdiction and its investor's jurisdiction results in payments being excluded from ordinary income in both jurisdictions.

DD outcomes include deductible hybrid entity payments, covering deductible payments made by a hybrid entity that could trigger a duplicate deduction in the parent jurisdiction; and deductible payments made by a dual resident company, involving payments made by a company treated as a resident by more than one jurisdiction.

Indirect D/NI outcomes apply only to imported mismatch arrangements, covering arrangements where the intermediary jurisdiction is party to a separate hybrid mismatch arrangement, and the payment from another jurisdiction to the intermediary jurisdiction under a non-hybrid arrangement is set off against a deduction arising under the hybrid mismatch arrangement to which the intermediary is a party.

The deliverable provides recommendations with a common format and succinct language. The format generally includes a Primary Rule for each country to adopt, a Defensive Rule (for another jurisdiction to apply where the Primary Rule is not in place), specifications for the types of entities and payments subject to the rule, and the scope of situations to which the rule applies. The recommendations only apply to payments that result in a hybrid mismatch. In general, the recommendations focus on denying deductions where there is a duplicate deduction or no income inclusion, with income inclusions as a backstop.

The proposed rules would apply mechanically, with no motive or purpose test. Hybrid payments are broadly defined and could include royalties or even payments for goods, but would not include deemed payments, such as notional interest deductions. A bottom-up approach is taken to scope and in several areas is restricted to related parties (with a 25% common ownership threshold), structured arrangements or controlled groups. Rules against deductible dividends and double deduction situations are proposed to have no scope restriction.

While the recommendations are nominally final, the report notes that deliverables from other workstreams to be subsequently delivered could impact the recommendations, and thus influence countries' law changes in this area. Also, further work remains to be done in 2015 on certain aspects of the report, such as potential restrictions on the scope of the imported mismatch rule, interaction with CFC rules and application of the recommendations to repo transactions, regulatory capital, and collective investment vehicles.

The OECD and G20 will consider the coordination of the timing of the implementation of these rules. It is possible that this may not be until after a Commentary and guidance have been produced, foreseen by September 2015.

Action 3: Strengthening controlled foreign corporation regimes

The OECD's Action 3 is to develop recommendations regarding the design of CFC rules. The OECD issued a discussion draft on CFC rules in March 2015. CFC rules tax certain income of controlled foreign subsidiaries in the hands of shareholders resident in the country of the ultimate parent.

Policy objectives for CFC regimes vary. Some countries with worldwide tax systems focus on long-term base erosion rather than profit-shifting. Other countries with more territorial tax systems do not currently have CFC rules or have more limited CFC regimes. The suggestion in this discussion draft is that CFC rules should address base erosion but also seek to prevent profit-shifting from third territories (with a particular focus on developing countries).

The main target of many CFC regimes is passive income. For example, both intellectual property (IP) royalties and interest income would generally be characterised as passive income and therefore included in the CFC income attributable to the parent. Although most OECD Member States apply CFC regimes, the OECD has done little work on this area in the past, and the rules vary greatly by jurisdiction.

The taxation of foreign income, derived directly or via a foreign subsidiary, is a key aspect of the fiscal policy of national governments to encourage economic growth, competitiveness and foreign investment. Before issuance of the OECD draft, it was considered unlikely that a common position on CFC rules could be achieved, because different jurisdictions have chosen a variety of different ways to approach taxing foreign income. The discussion draft does not change that view. The preliminary proposals offered by the CFC discussion draft are complex and, in practice, the difficulties are likely to be worsened by the degree of latitude accorded to states in applying or varying the proposed approach.

The OECD suggests that existing CFC rules do not always counter BEPS in a comprehensive manner. Stronger CFC rules will, in principle, lead to inclusion of more income in the residence country of the ultimate parent. Some countries have proposed that, in addition to 'primary rule' CFC measures, countries could introduce a 'secondary rule.' It would apply to income earned by CFCs that does not give rise to sufficient CFC taxation in the parent jurisdiction. This secondary form of taxation would apply in another jurisdiction (for example the source country of the income earned by the CFC), and it will add further complexity if ultimately recommended by the OECD.

The CFC discussion draft considers all the constituent elements of a CFC regime and breaks them down into the building blocks necessary for effective CFC rules. The recommendations are made with reference to each building block, and most of them include alternative options for jurisdictions that prefer a different approach consistent with existing domestic tax laws. The building blocks are:

The definition of a CFC
- The primary recommendation is to include more than just corporate entities.

Threshold requirements
- The primary recommendation is to have a low-tax threshold.

The definition of control
- The primary recommendation is to determine control using both legal and economic criteria – like vote and value tests under US law – with a 50% minimum control level.

The definition of CFC income
- There is no primary recommendation, just options offered, generally involving criteria based on substance of the entity.

Rules for computing income
- The recommendation is to use the parent jurisdiction's rules to calculate a CFC's income, but that jurisdiction should have a specific rule limiting the offset of CFC losses.

Rules for attributing income
- The attribution threshold should be tied to the minimum control threshold when possible.
- The amount of income attributed to each shareholder or controlling person should reflect both proportion of ownership and actual period of ownership or influence.
- Jurisdictions should be free to decide when and how income inclusions should occur.
- The tax rate of the parent jurisdiction should generally apply.

Rules to prevent or eliminate double taxation
- The recommendation is to allow a credit for foreign taxes actually paid (including CFC tax assessed on intermediate companies) and to exempt dividends and gains on disposition of CFC shares if the CFC's income has previously been subject to CFC taxation.

One proposal that has not achieved consensus yet but merits particular attention is an 'excess profits' approach under which income attributable under the CFC rules would be the profits in excess of a 'normal return', being a specific rate of return on the equity properly to be regarded as utilised in the business of the CFC. This approach echoes a proposal previously included in Obama Administration budgets.

In general, the CFC discussion draft reflects little consensus and seems unlikely to result in more uniform application of CFC regimes.

Action 4: Financial payments

In Action 4 of its BEPS Action Plan, the OECD seeks to target a broad range of what it describes as 'excessive' interest and other financial payments. The aim of Action 4 is to produce best practice rules to address BEPS through the use of interest expense. The discussion draft issued in December 2014 examines various current rules and their relative level of success, concluding that such rules do not generally address the underlying BEPS concerns.

The draft then looks at a number of different approaches and design features for rules designed to address BEPS through interest deductions, including group-wide rules, fixed financial ratio rules, targeted rules and combinations of these approaches. In addition to BEPS concerns, the paper also acknowledges other policy considerations, including minimising distortions to competition and investment, promoting economic stability, providing certainty, avoiding double taxation, and reducing administrative and compliance costs. In addition, there is acknowledgment of the need to consider a different approach to specific sectors, the importance of addressing EU law, and the interaction with other BEPS action items.

The Action 4 discussion draft does not reach firm conclusions, but it does identify two broadly-defined potential best practice rules:

- A group-wide interest allocation or ratio approach (group-wide tests). This would either limit an entity's net interest deductions to a proportion of the group's actual net third party interest expense, based on a measure of economic activity such as earnings or asset value (interest allocation), or limit interest deductions based on comparing a financial ratio for the entity with the equivalent group-wide ratio (such as net interest as a proportion of earnings). The interest allocation approach is broadly similar to a US budget proposal, and also has similarities to existing debt rules in the UK and other countries.
- A fixed ratio test operating to restrict interest expense to a specified proportion of earnings, assets or equity of a company. This type of approach is already widely used by a number of countries, for example the restriction of interest deductions based in Germany (using taxable EBITDA) or based in the United States (using adjusted taxable income). The paper acknowledges the difficulty in setting an appropriate benchmark ratio that is low enough to address BEPS concerns without giving rise to significant double taxation risk. The recommendation is to set the rate 'deliberately low,' and the OECD seems to believe that current ratios are all too high to deal effectively with BEPS risks.

  The paper also considers a combination of fixed ratio and group-wide ratio tests, including using one to be a backstop for the other. In all cases, the paper would exclude assets generating tax exempt or deferred income. The discussion draft also recommends that allocations or ratios be based on interest rather than debt, to deal more directly with BEPS concerns.

The discussion draft raises significant questions regarding impacts on investment choices and potential for double taxation, which may be addressed more effectively in a final report.

Action 5: Harmful tax practices

It is understandable that the OECD would wish to put the topic of harmful tax practices on the agenda of its BEPS Action Plan.

'Substantial activity' is the touchstone in the G20-approved report on harmful tax practices as it is throughout the BEPS Action Plan. The focus on aligning taxation with the 'substance' of transactions seems to be defined as determining where people are located, and where the performance of 'significant people functions' takes place. Nonetheless, determining the location of substantial activity is inevitably a subjective determination, making objective criteria difficult.

The report also voices concerns with regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services. There is some overlap of this work with that in the transfer pricing space relating to intangibles and risk and capital, as well as similar issues being addressed in the report on the tax challenges of the digital economy.

Criteria to assess whether preferential treatment regimes for intellectual property (patent boxes) are harmful have subsequently been agreed in principle. A solution proposed by Germany and the UK on how to assess whether there is substantial activity in an intellectual property regime has been endorsed and further formalised. The proposal, based around a 'nexus approach', allows a taxpayer to receive benefits on intellectual property income in line with the expenditures linked to generating the income. Transitional provisions for existing regimes, including a limit on accepting new entrants after June 2016, have been agreed, and work on implementation is ongoing.

Proposals for improving transparency through compulsory spontaneous exchange on taxpayer-specific rulings related to preferential regimes contribute to the third pillar of the BEPS project, which is to ensure transparency while promoting increased certainty and predictability. It should also be noted that the word 'compulsory' is understood to introduce an obligation to spontaneously exchange information wherever the relevant conditions are met, meaning this is a further step in moving more generally from exchange of information upon request to automatic exchange of information.

The work continues with consideration of the regimes of non-OECD members before then revising as required the existing harmful tax framework.

Action 6: Treaty abuse

According to the OECD, inefficiencies in tax treaties have triggered double non-taxation in a number of situations.

In September 2014, the OECD proposed three alternative approaches that countries could take to curb treaty shopping and other treaty abuses: (1) a limitation of benefits (LOB) provision accompanied by a principal purpose test (PPT), (2) an LOB accompanied by a narrower anti-abuse rule, or (3) a stand-alone PPT.

In revised proposals published in May 2015, two versions of the LOB were put forward. One version responds to the suggestion made by many respondents of limiting the LOB recommendations to a simplified version setting forth general standards and relying on the PPT to cover cases not caught by the LOB tests (the Simplified LOB). Another version includes a PPT within it and is combined with proposed Commentary addressing the possible addition to the LOB article of targeted provisions that were the source of both debate within the Working Group and criticism by stakeholders, questioning both the practicality and policy underpinnings of some of the proposed restrictions.

The Simplified LOB includes a basic version of most of the common LOB tests: individuals, governments, publicly traded entities, entities more than 50% owned by qualified persons, active trades or businesses, and discretionary grant of benefits. In addition, it includes a derivative benefits test for residents more than 75% owned by equivalent beneficiaries. The Simplified LOB lacks a rule to qualify pensions, charities, and collective investment vehicles; the main LOB includes a placeholder for such a rule.

The anti-conduit provisions to accompany a detailed LOB could, the OECD proposes, take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result. Examples of transactions that should and should not be considered to be conduit arrangements for this purpose are largely drawn from an exchange of letters with respect to the US-UK tax treaty.

Specific anti-abuse rules applicable to the detailed but not the simplified LOB include base erosion tests, substantial presence requirements, or disproportionate share rules. Other proposals currently under consideration include:

- A restriction on intermediate owners being resident to prevent the interposition of a company in a tax haven to which base-eroding payments could be made, but this could often result in ineligibility for treaty benefits where no treaty shopping is present.
- A denial of treaty benefits if the income is beneficially owned by a person subject to a special tax regime that provides a preferential effective rate of tax or if one of the treaty partners starts to exempt the income.
- A disallowance in the active trade or business test in considering the local activities of a connected person if the resident claiming treaty benefits (1) is subject to a special tax regime; or (2) is not engaged in the same or a similar line of business.
- A denial of treaty benefits with respect to income attributable to a permanent establishment (PE) effectively taxed at less than 60% of the general rate of company tax in the residence state, unless an active trade or business exception is satisfied.

On the PPT, obtaining benefits under a tax treaty need not be the sole or dominant purpose for the establishment, acquisition, or maintenance of the person and the conduct of its operations; rather, it is sufficient that at least one of the principal purposes was to obtain treaty benefits. Examples provide that it would not be reasonable to deny benefits where:

- A company acquires another business owned by a holding company and decides to retain that holding company because of treaty benefits.

- A company establishes an intra-group service provider in a jurisdiction based on that jurisdiction's skilled labour force, reliable legal system, business-friendly environment, political stability, membership in a regional grouping, sophisticated banking industry, and comprehensive double tax treaty network.
- A company invests in a contracting state through a subsidiary based in the other contracting state where the latter subsidiary carries on diverse business activities as part of an active trade or business.
- Two companies enter into cross-licensing arrangements to ensure that withholding tax is collected at the correct treaty rate on cross-licensing royalties without the need for a broad population of individuals each to apply for a refund on small payments.
- The revised proposals also address issues with respect to publicly traded companies, the timely availability of discretionary relief, the residency tie-breaker rule, and the application of domestic anti-abuse rules to claims of treaty benefits.

Action 7: Artificial avoidance of PE status

More countries have recently been challenging overseas companies on the presence in their jurisdiction of a PE – so it is no surprise that the OECD would choose to pursue this area in its BEPS Action Plan.

Although one of the shortest papers so far released, various options proposed in the 3 November 2014 discussion draft included fundamental changes to the existing PE rules, with a potentially wide impact on many structures currently in use by MNEs. Revised proposals, published in May 2015, replaced the alternative approaches to a number of significant PE issues with a set of definitive proposals.

They include widening the dependent agent provisions and narrowing both the independent agent exemptions and the specific activity (e.g., warehouses, etc.) exemptions, and go beyond the PE areas identified for review under Action 7 in the original BEPS Action Plan.

Separate areas in which the OECD is proposing change include:

- commissionaire arrangements and similar strategies (broadening the current recognition of the conclusion of contracts on behalf of an enterprise to include negotiating the material elements of contracts that are in the name of that enterprise, or that, broadly, relate to property of that enterprise or which are for the provision of services by that enterprise, with exclusions for independent agents only where they act for a wider group of people)
- insofar as the OECD wishes to restrict the existing specific activity exemptions which allow certain activities to take place in a state without triggering the threshold PE rule, it is proposed to restrict all of those exemptions to activities that are of a 'preparatory or auxiliary' character with additional Commentary to clarify their scope; the ability of companies to fragment activities is also restricted where the combined business activities represent "complementary functions that are part of a cohesive business operation"
- rules to counter the splitting up of contracts aim to prevent the circumvention of the 12 month 'construction site' PE rule (which also covers installation projects)
- PE profit attribution issues (the OECD seems to proceed largely on the basis of an expectation of an increase in profits to such PEs but the precise reasoning is not included).

It is inevitable that the proposed changes would lead to a material shift towards source-based taxing rights. There would also be a material increase in uncertainty given the greater use of subjective tests in what is proposed. The existing strained dispute resolution system would come under increasing pressure and alternative means of preventing and resolving disputes and audits should be given a high priority.

Action 8: Transfer pricing and intangibles

The OECD has published final and interim revisions in relation to Chapters I, II, VI and VIII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. These revisions have been developed in connection with Action 8 of the Action Plan on BEPS that is focused on ensuring that transfer pricing outcomes with respect to intangibles are in line with value creation activities. The revisions to the guidelines addressing the transfer pricing aspects of intangibles show the direction in which the OECD had been thinking on key issues related to identification and valuation of intangibles, a topic that had been debated among governments before the BEPS Action Plan was published.

In several discussion drafts associated with work streams related to intangibles, the OECD has emphasised that the starting point to this analysis begins with an evaluation of a group's global value chain to show how intangibles interact with other functions, risks and assets. However, the emphasis is on the importance of accurately delineating the actual transaction and the possibility of recharacterisation or non-recognition of transactions has been highlighted (see Action 9).

There are proposals on the arm's-length pricing of intangibles when valuation is highly uncertain at the time of the transaction or the intangibles are hard to value. The OECD proposed that a tax authority may impute adjustment or renegotiation clauses in related-party contracts if it determines that independent parties would have used such mechanisms, but announced in its July 2015 public consultation that this position is to be reconsidered based on the real terms of the transaction and the parties' behaviour pursuant to the contract. Further, under the current draft paper, ex-post information should be used for a new category of 'hard-to-value intangibles', defined as those for which – at the time of their transfer in a transaction between associated enterprises:

- no sufficiently reliable comparable exists,
- there is a lack of reliable projections of future cash flows or income expected to be derived from the transferred intangible, or
- the assumptions used in valuing the intangible are highly uncertain.

Combined with special measures, to be further developed in 2015, the revised guidelines aim to prevent an MNE group member that merely assumes funding risk related to an intangibles transacti0n, without performing and controlling certain identified 'important functions', providing all assets and bearing and controlling all risks in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles from earning more than a risk-adjusted rate of anticipated return on its funding.

Modified guidelines are proposed where intangibles are developed under cost contribution arrangements (CCAs). These apply with respect to measuring the value of contributions to CCAs, the effect of government subsidies or tax incentives, and the tax characterisation of contributions, balancing payments and buy-in/buy-out

payments. The main aim is to ensure that contributions are commensurate with the benefits received under a CCA. However, a requirement for any participant in a CCA to have the "capability and authority to control the risks associated with the risk-bearing opportunity" would unnecessarily impair the usefulness of CCAs. The need to measure contributions based on value rather than costs is inappropriate except in the case of development CCAs (or possibly also service CCAs when the services cannot be qualified as low value-added).

On the revised definition of intangibles, Chapter VI will state the importance of distinguishing between intangibles and market conditions or local market circumstances, which are not capable of being owned or controlled. A key theme of the discussion drafts addressing intangibles is that the extent to which a member of an MNE possesses control over risks, assets, or outcomes is material to evaluating whether intangible-related returns generated from the transaction should be allocated to the MNE member entity.

Regarding location savings or local market features, the most reliable approach is stated to be local market comparables and only if they don't exist to consider advantages and disadvantages and whether they are passed on to customers.

The benefits of an assembled and experienced workforce may affect the arm's-length price. In general, the transfer of such people within an MNE should not be separately compensated but reflected to the extent that there are time and costs savings (except where there is a transfer of know-how or other intangibles). In certain limited instances, the transfer or secondment of individual employees could be a transfer of know-how or related intangibles.

Group synergies should result in arm's-length remuneration only if they arise from deliberate concerted group actions that provide a member of an MNE group with material burdens or advantages not typically available to comparable independent entities. The revised guidelines contemplate that such an analysis can only be determined through a functional and comparability analysis.

Action 9: Transfer pricing and risks/capital

One key aspect of the Action Plan is its indication that in some instances, special measures, either within or beyond the arm's-length principle, may be required to address the perceived flaws in the international tax system with respect to intangibles. This point remains a substantial topic of debate and is especially apparent in the controversial OECD discussion draft addressing risk, recharacterisation and special measures as part of Action 9 of the OECD BEPS Action Plan.

Action 9 of the OECD BEPS Action Plan is designed to develop rules to prevent base erosion and profit shifting through the transfer of risks among – or the allocation of excessive capital to – group members. On 19 December 2014, the OECD released a transfer pricing discussion draft within Actions 8-10 covering risk and situations calling for recharacterisaton or 'special measures'. Based on the extensive comments received from the business community, it is likely that many of the more controversial elements of this discussion draft will be modified in the OECD's next release expected in October 2015, as announced by the OECD during the July 2015 public consultation. . However, the proposals emphasise the importance of accurately delineating the actual transactions, and include guidance on the relevance and allocation of risk,

determining the economically relevant characteristics of the controlled transaction, and on recharacterisation or non-recognition of transactions. One basic theme of the modifications is that, while contractual allocations of risk may be a starting point, such contractual allocations are subject to a substantive analysis of the economic behaviour of the parties in the context of the entire value chain of the MNE, the substance of the risk-bearing entity, and the parties' behaviour pursuant to the contract terms.

Action 10: Transfer pricing and other high-risk transactions

The objective of action 10 in the OECD's BEPS Action Plan is to develop rules to prevent abusive transactions which would not, or would only very rarely, occur between unrelated parties. The OECD's work in this area includes drafts published on Transfer Pricing for Low Value-Adding Services, Use of Profit Split Methods in the Context of Global Value Chains, and Transfer Pricing Aspects of Cross-border Commodities Transactions.

Proposed modifications to Chapter VII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations for management fees and other low value-adding services do not yet represent a consensus view and are intended to provide stakeholders with substantive proposals for analysis and comment.

The Working Party seems to have taken a step in the right direction to achieve a balance between appropriate charges and protecting the tax base, but the draft fails to substantially address how the additional guidance will be impacted by the other BEPS work.

These proposals mainly consist of an elective, simplified alternative approach to the usual transfer pricing exercise.

There is a definition of what constitutes the low value-adding services that would be covered and a number of examples of things which the OECD doesn't consider as qualifying.

The single mark-up to be utilised for all these services would function as a safe-harbour and thus not require to be supported by a benchmarking study and would be between 2 percent and 5 percent of the relevant cost base.

Action 10: Transfer pricing aspects of cross-border commodity transactions

The OECD discussion draft on transfer pricing for commodity transactions seeks to reconcile developments in taxing commodity transactions with existing transfer pricing guidance. The draft focuses on the broadly-defined 'Sixth Method.' The Sixth Method is the established method for the purposes of commodity-specific taxation in many developed countries (e.g., petroleum revenue tax in the UK or Norway). This method has also recently increased in popularity for other commodities in developing countries.

The draft takes the position that the Sixth Method in all its versions is essentially a variation of the Comparable Uncontrolled Price (CUP) method. Thus, the draft concludes that the Sixth Method, if properly applied, can be reconciled with OECD transfer pricing principles.

The discussion draft suggests wording for the OECD Transfer Pricing Guidelines that would effectively create a framework for tax authorities and taxpayers to apply Sixth Method within existing transfer pricing systems. This would operate particularly with respect to comparability adjustments to quoted prices, which the draft acknowledges would be needed in applying the CUP method to account for physical differences, different specifications, freight, etc.

The discussion draft acknowledges that tax authorities in developing countries may have limited expertise and resources for verifying the pricing date used. Pricing in the commodities industry is complex, with many variations, so setting a single rule for pricing dates may be challenging. In fact, it may not be possible to price certain commodities (e.g., power) at delivery. Other activities, such as pricing of optionality around delivery dates, may need to be accounted for by means other than pricing dates (e.g., by comparability adjustments).

The discussion draft specifies that the BEPS project will provide additional guidance relevant to commodity-related transactions under Actions 9 (on risk and capital), 10 (especially on recharacterisation and low value-adding services) and 13 (transfer pricing documentation and CbC reporting).

Many commodity-dependent developing countries are not members of the OECD and may not adopt all aspects of the OECD transfer pricing guidance. It would be helpful if the final recommendations encourage consistency on a global basis. The alternative could be new countries introducing different variations of the Sixth Method as an application of the CUP method. The OECD is expected to finalise this paper by October 2015.

Action 10: Profit splits

A Discussion Draft deals specifically with the Use of profit splits in the context of global value chains. This is part of the wider item 10 of the BEPS Action Plan dealing with assuring that transfer pricing outcomes are in line with value creation. According to paragraph seven of the Discussion Draft, “where there is significant integration involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key functions and risks, the reliability of one-sided methods may be reduced”.

The Discussion Draft recommends transactional profit splits may be more reliable than one-sided methods where there is pooling of entrepreneurial functions and risks and the success of the business depends on integration of related parties. The Discussion Draft notes that transactional profit splits may be appropriate where an MNE’s business is highly integrated and strategic risks may be jointly managed and controlled by more than one entity. Such an analysis therefore requires an appropriate consideration of strategic risk, further confirming the OECD’s continued reliance on detailed functional analyses. Many MNEs split functions within a value chain whereby certain entities undertake only limited, specific functions (e.g., logistics, marketing etc.). Due to fragmentation, the Discussion Draft argues that comparables that are similarly limited to comparable specific and discrete functions may be difficult to identify. As such, it may be preferable to undertake a transactional profit split approach as a corroborative method identifying comparable companies that combine multiple functions and utilising the principles of a contribution analysis to divide the benchmarked profit.

Such an analysis appears aligned with a reliability analysis in determining the best comparables in the marketplace to be used as benchmarks.

The Discussion Draft's reliance on the use of transactional profit split as a corroborative method raises a level of concern that a one-sided analysis may, because of a default preference to profit split based on the overarching language in the draft, be eschewed when it is otherwise appropriate and reliable. In scenarios where one-sided methods are appropriate and reliable based on a thorough functional analysis, corroborative profit split methods may be a precursor to formulary apportionment, as they may improperly suggest higher returns to entities performing routine functions that can be reliably benchmarked.

The OECD announced at the July 2015 public consultation that the revised paper will be more in line with the arm's-length principle and selection of the most appropriate method, and that a final paper will likely not be completed until 2016.

Action 11: Data and methodologies

Action 11 reflects the OECD's apparent goal of establishing methodologies to collect and analyse data on BEPS and to focus on actions to address the analytical findings.

There are some firm conclusions about indicators of BEPS in the discussion draft published on 16 April 2015 but there is also recognition that assessing the extent of BEPS is 'severely constrained' and no attempt is made in the draft to ascertain an overall figure for total BEPS. In fact, many of the existing attempts to do so are fairly heavily criticised.

Much of the draft deals with broad indicators of BEPS:

- Relative concentration of net foreign direct investment (FDI) to GDP.
- High profit rates of low-taxed affiliates of top global MNEs.
- High profit rates of MNE affiliates in lower tax countries.
- Profit rates compared to effective tax rates (ETRs) for MNE domestic and foreign operations.
- ETRs of MNEs compared to comparable domestic firms.
- Relative concentration of royalty payments relative to R&D expenditures.
- Interest expense to income ratios of top global MNE affiliates in high statutory tax rate countries.

Two approaches are put forward as alternative ways of seeking to measure BEPS:

- extrapolating from studies assessing the impact of tax rate differentials on the movement of profit from one location to another, and
- adding the amounts identified for each separate BEPS channel (per the Action Plan) with an adjustment for interactions between them.

Existing data sources are considered but questions remain as to whether there are other sources and whether the data will be adequate to perform reliable analyses.

The discussion draft does not discuss new tools to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS, or new types of data that might be useful in helping to analyse BEPS in the future.

However, it is potentially a concern for MNEs that the draft suggests confidential data could be used or more data might be necessary. No recommendation is made as to whether business should be asked to provide that data.

Action 12: Disclosure of aggressive tax planning

The OECD is aiming to require taxpayers to disclose aggressive tax planning arrangements. Action 12 of the BEPS Action Plan targets this objective.

A new discussion draft of 31 March 2015 deals primarily with the first two elements of this part of the BEPS package:

- design of mandatory disclosure rules or a mandatory disclosure regime (MDR), and
- a focus on international tax schemes.

The other elements:

- coordination with work on cooperative compliance, and
- enhanced models of information sharing between tax administrations will be addressed in due course, partly under BEPS and partly in other initiatives.

There is a need to identify mass marketed pre-packaged schemes or those which rely on limited or no disclosure and which aim to provide absolute tax benefits or cash flow advantages from delays in paying the tax due. However, the challenge will be to target such schemes without creating an enormous compliance burden for the vast majority of MNEs and intermediaries whose commercial affairs happen to need cross-border advice.

In keeping with the intention to adopt a modular approach, the discussion draft sets out a number of features of existing MDRs. It is not clear whether the OECD recommends countries implement MDRs including, in particular, when they have other ways in which they satisfy their perceived information requirements. Significant work may be needed to confirm whether a disclosure has to be made following the introduction or extension of a specific regime as put forward in this discussion draft. In many cases, the outcome will be that no disclosure is needed.

Changes in international tax standards and other promised increases in cooperation between jurisdictions and alternative methods for addressing avoidance activity also suggest a serious review of the costs and potential benefits is needed before the recommendation of any new disclosure regime for international tax arrangements.

Action 13: Transfer pricing documentation

Action 13 of the OECD's BEPS Action Plan is aimed at re-examining transfer pricing documentation requirements – and in particular providing for more information from taxpayers.

The proposals now agreed by the G20 on the transfer pricing documentation master file and local file are broadly in line with what has already been announced while on CbC reporting. The report now confirms that the data points that will be required to be reported for each country will be the following:

- Revenues (from both related and unrelated-party transactions)
- Profit before income tax
- Income tax paid (cash basis)
- Current year income tax accrual
- Stated Capital
- Accumulated earnings
- Number of employees
- Tangible assets (excluding cash and equivalents)

The clear implication is that the template is designed to highlight those low-tax jurisdictions where a significant amount of income is allocated without some ‘proportionate’ presence of employees. What this means in practice is that there will be pressure to assure that profit allocations to a particular jurisdiction are supported by the location in that State of sufficient, appropriately qualified employees who are able to make a ‘substantial contribution’ to the creation and development of intangibles. Concerns regarding confidentiality of this data and the potential for adjustments by tax administrations based on a formulary apportionment approach leading to many more transfer pricing controversies have already been noted.

The OECD has also noted that some countries (for example Brazil, China, India, and other emerging economies) would like to add further data points to the template regarding interest, royalty and related-party service fees. Those data points will not be included in the template in this report, but the compromise is that the OECD has agreed that they will review the implementation of this new reporting and, before 2020 at the latest, decide whether there should be reporting of additional or different data.

The OECD finalised its arrangements for the sharing of master file and CbC information in February 2015, including protections that would preserve the confidentiality of the country-by-country report (CbCR) to an extent at least equivalent to the protections that would apply if such information were delivered to the country under the provisions of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a TIEA or a tax treaty.

The OECD proposals would require tax administrations to ensure multinationals with a turnover above EUR 750 million in their countries of residence start using the reporting template for fiscal years beginning on or after 1 January 2016 with tax administrations beginning to exchange the first CbCRs in 2017. A “Country-by-Country Reporting Implementation Package” published on 12 June 2015 includes model legislation the OECD suggests could be used by countries to mandate filing of CbCRs and model competent authority agreements that could be used by each country to effect the information exchange. Neither the model legislation nor any of the model competent authority agreements contains additional guidance regarding the particular data that multinational enterprises (MNEs) need to provide in the CbCRs.

Action 14: Make dispute resolution mechanisms more effective

On 18 December 2014, the OECD released its discussion draft on Action 14. During the last decade, the OECD has issued guidance to improve dispute resolution mechanisms, including the Manual on Effective Mutual Agreement Procedures (MEMAP) in 2007. Today's global tax controversy environment, however, calls for a more focused effort to improve the effectiveness of the Mutual Agreement Procedures (MAP) in resolving treaty-related disputes. The discussion draft acknowledges that it does not present a consensus view of the Committee on Fiscal Affairs and the discussion only provides proposals and options to arrive at measures that will constitute a minimum standard to which participating countries will commit. Further, the discussion draft acknowledges that a universal adoption of mandatory binding arbitration would be difficult, if not impossible, in the immediate term to achieve, and therefore suggests the need for complementary solutions that are practical and impactful. The discussion draft specifically focuses on obstacles that prevent resolving disputes and identifies corresponding measures and options to address such obstacles. Taking a holistic view, the draft should be read in the context of a three-pronged approach that would improve resolution of disputes through MAP. This three-pronged approach would: (i) consist of political commitments to effectively eliminate taxation not in accordance with the tax convention; (ii) provide new measures to improve access to MAP and improved procedures; and (iii) establish a monitoring mechanism to check the proper implementation of the political commitment.

The political commitment and the measures to improve MAP are grounded in four principles that form the basis of the OECD's recommendations. These four principles are the framework of the discussion draft:

- Ensuring that treaty obligations related to MAP are fully implemented in good faith.
- Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes.
- Ensuring that taxpayers can access MAP when eligible.
- Ensuring that cases are resolved once they are in MAP.

Specific measures that will implement the political commitment will be determined as part of future work on Action 14. Such measures will likely be supplemented by a monitoring process that will evaluate the functionality of MAP and include an overall assessment as to the commitment made by individual countries. This monitoring process, while not described in the discussion draft, is expected to be performed by a select forum of competent authorities.

Action 15: Creation of a multilateral instrument

The final action of the BEPS Action Plan is the development of a multilateral instrument that countries can use to implement various treaty-related measures developed in the course of the work.

Released 24 September 2014, the Action 15 OECD paper confirmed that a multilateral instrument is both desirable and, from a tax and public international law perspective, technically feasible.

The OECD's BEPS Action Plan

On 6 February 2015, OECD and G20 countries agreed a mandate for negotiations for the agreement of a multilateral convention with an aim to conclude discussions by 31 December 2016.

It was clarified that the purpose would be restricted to the updating of bilateral treaties, and not be extended to other things, such as to 'express commitments' to implement certain domestic law measures or provide the basis for exchange of the CbC template, discussed above.

Work on the development of the Multilateral Instrument began on 27 May 2015 in Paris. As per the mandate, the ad hoc Group that will complete the work under Action 15 has been established, with over 80 countries participating (the US being a notable absentee at this stage). At the meeting, members of the Group appointed Mr. Mike Williams of the UK as Chair, and Mr. Liao Tizhong of the People's Republic of China, Mr. Mohammed Amine Baina of Morocco and Mrs. Kim S. Jacinto-Henares of the Philippines as Vice-Chairs. Participants also agreed on a number of procedural issues so that the substantive work can begin at an Inaugural Meeting which will take place on 5-6 November 2015 (back-to-back with the 20th Annual Tax Treaty Meeting for government officials which will take place on 3-4 November 2015). A number of international organisations will also be invited to participate in the work as Observers.

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Part 2: Country-specific issues

12.

Argentina

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Overview

The Argentine Federal Tax Authority (AFIP) on 19 December 2013 released resolutions 3572/13 and 3573/13, which create registries and information regimes for affiliated parties and joint ventures, and other non-corporate entities involved in domestic and international transactions.

Argentinian resident corporations, partnerships, trusts in general, and trusts in which the settlor and the beneficiary are the same person (the obligors) must register with the registry of affiliated parties if they are affiliated to any other party incorporated, domiciled, or situated in Argentina or abroad.

Additionally, the obligors must act as information agents for domestic transactions performed with affiliated parties (as described in Annex I of Resolution 3572/13) that are incorporated, domiciled, or situated in Argentina. That requirement is in addition to the transfer pricing (TP) information obligations for cross-border transactions.

Regarding the audit environment, local tax authorities have continued with a strong audit programme, and sometimes, focus on certain industries (pharmaceutical, commodities, exporters); while in other cases the analysis is oriented on certain types of transactions (management fees, technical assistance, financial transactions).

Country	**Argentina**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes

Argentina

Country	Argentina
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	During the eighth month following the end of the FY
Must TP documentation be prepared in the official/ local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	In the event that the taxpayer's conduct is considered an omission, a fine must be paid that varies between one and four times the unpaid tax. Also, there are fixed penalties for formal infringements.

Introduction

Argentinian TP regulations have existed, in some form, since 1932. Prior to 1998, the rules focused on the export and import of goods through application of the wholesale price method, comparing the price of imports and exports with the wholesale price of comparable products in the markets of origin or destination. This methodology was applied unless the parties to the transaction could demonstrate that they were not related parties (Article 8 of the Income Tax Law [ITL]).

Article 14 of the ITL reflected the need for all transactions to comply with the arm's-length standard:

"Transactions between a local enterprise of foreign capital and the individual or legal entity domiciled abroad that either directly or indirectly control such enterprise shall, for all purposes, be deemed to have been entered into by independent parties, provided that the terms and conditions of such transactions are consistent with normal market practices between independent entities, with limits to loans and technical assistance."

However, the rules did not include any methodologies for supporting inter-company transactions, or outline any documentation requirements.

On 30 December 1998, pursuant to Law 25,063, Argentina adopted general guidelines and standards set forth by the Organisation for Economic Co-operation and Development (OECD) including the arm's-length standard, and applied it to tax years ending on, or after, 31 December 1998. With the adoption of the OECD standards, the computation of a taxpayer's income-tax liability including provisions governing the selection of appropriate TP methodologies for transactions between related parties, could be impacted.

On 31 December 1999, Law 25,063 was updated with Law 25,239, which introduced the special tax return and documentation requirements in relation to inter-company transactions. Under the TP reform process, the old wholesale price method was

only applicable to transactions involving imports or exports of goods between unrelated parties.

On 22 October 2003, Law 25,784 introduced certain amendments to the ITL which affected TP regulations. One of the amendments related to one of the points of an anti-evasion programme, with one of its objectives being to control evasion and avoidance in international operations resulting from globalisation. On the one hand, Law 25,784 replaces regulations on the import and export of goods with related and unrelated parties (replacement of Article 8 of the ITL), eliminating the concept of wholesale price at the point of destination or origin as a parameter for comparison. Now, in the case of imports or exports of goods with international prices known through commonly traded markets, stock exchanges, or similar markets, the new parameter establishes that those prices will be used to determine net income. On the other hand, a new TP method is introduced for the analysis of exports of commodities (amendments to Article 15 of the ITL).

Taxpayers currently have two important TP-related obligations: to prepare, maintain and file transfer pricing documentation; and to file three information returns (special tax returns) on transactions with non-resident-related parties. In addition, taxpayers are required to maintain some documentation on import or export of goods between unrelated parties and to fill information returns on such transactions.

On 14 November 2003, Law 25,795 was published in the official gazette (modifying Procedural Law 11,683), establishing significant penalties for failure to comply with TP requirements.

It is important to note that the tax authorities are currently conducting an aggressive audit programme including a number of TP audits that are under way.

Legislation and guidance

Statutory rules

Effective 31 December 1998, Argentinian taxpayers must be able to demonstrate that their transactions with related parties outside of Argentina are conducted at arm's length. Transfer pricing rules are applicable to all types of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions, and licensing of intangible property). Under Argentinian legislation, there is no materiality factor applicable, and all transactions must be supported and documented.

Transfer pricing rules apply to:

- Taxpayers who carry out transactions with related parties organised, domiciled, located, or placed abroad and who are encompassed by the provisions of Article 69 of the ITL, 1997 revised text, as amended (mainly local corporations and local branches, other types of companies, associations, or partnerships), or the addendum to Clause D of Article 49 of the ITL (trusts or similar entities).
- Taxpayers who carry out transactions with individuals, or legal entities domiciled, organised, or located in countries with low or no taxation, whether related or not (On 7 January 2014, the Argentinian Government issued Decree 589/2013, which eliminated the list of no- or low-tax jurisdictions from the income tax regulations (the so-called 'black list') and empowered AFIP to establish a new 'white list' of

countries, territories and tax regimes that are considered to be 'cooperative' with respect to tax transparency. Cooperative countries are those that have signed either double tax treaties (DTTs) with broad exchange of information clauses or tax information exchange agreements (TIEAs) with Argentina, or that are in the process of negotiating a DTT or TIEA).
- Taxpayers resident in Argentina, who carry out transactions with permanent establishments (PEs) abroad that they own.
- Taxpayers resident in Argentina who are owners of PEs located abroad, for transactions carried out by the latter with related parties domiciled, organised, or located abroad, under the provisions of Articles 129 and 130 of the ITL.

Related parties
The definition of related party under Argentinian TP rules is rather broad. The following forms of economic relationship are covered:

- One party that owns all or a majority of the capital of another.
- Two or more parties that share: (i) one common party that possesses all or a majority of the capital of each; (ii) one common party that possesses all or a majority of the capital of one or more parties and possesses significant influence over the other or others; and (iii) one common party that possesses significant influence over the other parties.
- One party that possesses the votes necessary to control another.
- One or more parties that maintain common directors, officers, or managers/administrators.
- One party that enjoys exclusivity as agent, distributor, or licensee with respect to the purchase and sale of goods, services and intangible rights of another.
- One party that provides the technological/intangible property, or technical know-how that constitutes the primary basis of another party's business.
- One party that participates with another in associations without a separate legal existence pursuant to which such party maintains significant influence over the determination of prices.
- One party that agrees to preferential contractual terms with another that differs from those that would have been agreed to between third parties in similar circumstances including (but not limited to) volume discounts, financing terms and consignment delivery.
- One party that participates significantly in the establishment of the policies of another relating to general business activities, raw materials acquisition and production/marketing of products.
- One party that develops an activity of importance solely in relationship to another party, or the existence of which is justified solely in relationship to such other party (e.g. sole supplier or customer).
- One party that provides a substantial portion of the financing necessary for the development of the commercial activities of another including the granting of guarantees of whatever type in the case of third-party financing.
- One party that assumes responsibility for the losses or expenses of another.
- The directors, officers, or managers/administrators of one party who receive instructions from, or act in the interest of another party.
- The management of a company is granted to a subject (via contract, circumstances, or situations), which maintains a minority interest in the capital of such company.

Methodology
For the export and import of goods between unrelated parties, the international price is applicable. In the event that the international price cannot be determined, or is not available, the taxpayer (the exporter or importer of the goods) must provide the tax authorities with any information available to confirm whether such transactions between unrelated entities have been carried out, applying reasonable market prices (Article 8 of the ITL).

For related-party transactions, both transactional and profit-based methods are acceptable in Argentina. Article 15 of the ITL specifies five TP methods (an additional method has been established, dealing with specific transactions):

1. Comparable uncontrolled price method (CUP).
2. Resale price method (RPM).
3. Cost-plus method (CP).
4. Profit split method (PSM).
5. Transactional net margin method (TNMM).
6. Specific method for export transactions involving grain, oilseed and other crops, petroleum and their derivatives and, in general, goods with a known price in transparent markets (sixth method).

This last method will only be applied when: (i) the export is made to a related party; (ii) the goods are publicly quoted on transparent markets; and (iii) there is participation by an international intermediary that is not the actual receiver of the goods being sold.

It should be noted that this method will not be applicable when the international intermediary complies with all the following conditions:

- Actual existence in the place of domicile (possessing a commercial establishment where its business is administered, complying with legal requirements for incorporation and registration, as well as for the filing of financial statements).
- Its main activity should not consist of the obtaining of passive incomes, or acting as an intermediary in the sale of goods to, and from, Argentina, or other members of its economic group.
- Its foreign trade transactions with other members of the group must not exceed 30% of the annual total of its international trading transactions.

The method consists of the application of the market price for the goods being exported on the date the goods are loaded. This applies, regardless of the type of transport used for the transaction and the price that may have been agreed with the intermediary, unless the price agreed with the latter were to be higher than that determined to be the known price for the goods on the date of loading. In such a case, the higher of the two prices should be used to determine the profit of the Argentinian source.

Under the above-mentioned circumstances, the Argentinian tax authorities disregard the date of transaction for these types of operations and consider the date of loading, assuming the date of the transactions could be manipulated by the related parties. In addition, they apply the same methodology, even when the foreign intermediary was an unrelated party.

Best method rule

There is no specific priority of methods, except for the sixth method. Instead, each transaction or group of transactions must be analysed separately to ascertain the most appropriate of the five methods to be applied (i.e. the best method must be selected in each case). The TP regulations provide that in determining the best method to apply in a given circumstance, consideration will be given to:

- the method that is most compatible with the business and commercial structure of the taxpayer
- the method that relies upon the best quality/quantity of information available
- the method that relies upon the highest level of comparability between related and unrelated-party transactions, and
- the method that requires the least level of adjustments in order to eliminate differences existing between the transaction at issue and comparable transactions.

Tested party

The regulations established by the tax authority have stated that the analysis of the comparability and justification of prices – when applying the methods of Article 15 – must be made, based on the situation of the local taxpayer.

Penalties

If the Argentinian tax authorities are not in agreement with a taxpayer's transfer prices, any tax difference should be paid, together with restatement and interest (which is not based on a specific public interest rate). In the event that the taxpayer's conduct is considered an omission, a fine must be paid that varies between one and four times the unpaid tax. In cases where the tax authorities determine that the taxpayer has deliberately manipulated the amounts, fines could be assessed for up to ten times the evaded tax liability, notwithstanding the penalties stipulated in the Criminal Tax Act (Law 24,769). The tax authorities have the discretion to analyse the TP arrangement(s) by consideration of any relevant facts and application of any methodology they deem suitable.

Penalties for non-compliance with respect to international transactions are as follows:

- Failure to submit an informative tax return on imports and exports between independent entities is penalised with a fine of 1,500 Argentine pesos (ARS) which is raised to ARS 9,000 when an entity belongs to a foreign subject.
- Failure to submit a tax return for all other import and export transactions with foreign related subjects is penalised with a fine of ARS 10,000, which is raised to ARS 20,000 when the entity belongs to a foreign subject.
- Failure to provide correct tax address, information regarding international transactions, or supporting documentation for transfer prices, as well as obstructing an inspection, is penalised with amounts between ARS 150 and ARS 45,000.
- Failure to comply with the requirements of the AFIP regarding the submission of informative tax returns for transactions with foreign-related entities, and regarding the submission of proprietary or third-party information, is penalised with fines between ARS 500 and ARS 45,000. Following three non-compliances the fine will be raised to between ARS 90,000 and ARS 450,000 for taxpayers whose income is equivalent to, or above, ARS 10 million.

It is important to mention that on 15 March 2013, the Tax Court confirmed the penalty of ARS 20,000 imposed by the Argentine tax authorities to the company *Petersen Thiele y Cruz S.A. de Construcciones y Mandatos* for omitting filing the informative tax return.

Documentation

The Argentinian income-tax law requires that the AFIP promulgate regulations requiring the documentation of the arm's-length nature of transactions entered into with related parties outside of Argentina. In this regard, the TP regulations require that taxpayers prepare and file special tax returns detailing their transactions with related parties. These returns must be filed along with the taxpayer's corporate income tax return.

Information returns

Import and export transactions between unrelated parties:

- Requirements have been established for information and documentation regarding import and export of goods between unrelated parties (Article 8 of the ITL) covering international prices known through commonly traded markets, stock exchanges, or similar markets, which will be used to determine the net income. A semi-annual tax return must be filed in each half of the fiscal year (Form 741).
- In the case of import and export transactions of goods between unrelated parties for which there is no known internationally quoted price, the tax authorities shall be able to request the information held in relation to cost allocation, profit margins and other similar data to enable them to control such transactions, if they, altogether and for the fiscal year under analysis, exceed the amount of ARS 1 million. A yearly tax return must be filed for those import and export of goods between unrelated parties for which there is no known internationally quoted price (Form 867).
- In cases of transactions with parties located in countries with low or no taxation, the methods established in Article 15 of the law must be used, and it will be necessary to comply with the documentation requirements described for the transactions covered by TP rules. The obligation to document and preserve the vouchers and elements that justify the prices agreed with independent parties is laid down, and minimum documentation requirements are established.

Compliance requirements for transactions with related parties:

- Six-month tax return, for the first half of each fiscal period (Form 742).
- Annual tax return covering the entire fiscal year (Form 969).
- Complementary annual tax return, also covering the entire fiscal year (Form 743), which includes information about the TP methodology included in the report and the TP adjustment in case it is applicable.
- Transfer Pricing documentation (certificated by the corresponding professional body) must be submitted to the tax authorities between the third and seventh day of the eighth month after the fiscal year-end.

The report must contain the information detailed below:

- Activities and functions performed by the taxpayer.
- Risks borne and assets used by the taxpayer in carrying out such activities and functions.
- Detail of elements, documentation, circumstances and events taken into account for the analysis, or transfer price study.
- Detail and quantification of transactions performed and covered by this general resolution.
- Identification of the foreign parties with which the transactions being declared are carried out.
- Method used to justify transfer prices indicating the reasons and grounds for considering them to be the best method for the transaction involved.
- Identification of each of the comparables selected for the justification of the transfer prices.
- Identification of the sources of information used to obtain such comparables.
- Detail of the comparables selected that were discarded, with an indication of the reasons considered.
- Detail, quantification and methodology used for any necessary adjustments to the selected comparables.
- Determination of the median and the interquartile range.
- Transcription of the income statement of the comparable parties corresponding to the fiscal years necessary for the comparability analysis, with an indication as to the source of the information.
- Description of the business activity and features of the business of comparable companies.
- Conclusions reached.

Nevertheless, if a TP adjustment was applicable, it must be included in the annual tax return for which filing is due on the fifth month after the fiscal year-end. From fiscal years ending 31 December 2012, the TP report must be filed electronically (through the Form 4501).

The Argentinian tax authority on 19 December 2013 released resolutions 3572/13 and 3573/13, which created registries and information regimes for affiliated parties and joint ventures, and other non-corporate entities involved in domestic and international transactions.

Argentinian resident corporations, partnerships, trusts in general, and trusts in which the settlor and the beneficiary are the same person (the obligors) must register with the registry of affiliated parties if they are affiliated to any other party incorporated, domiciled, or situated in Argentina or abroad.

Additionally, the obligors must act as information agents on a monthly basis for domestic transactions performed with affiliated parties (as described in Annex I of the Resolution 3572/13) that are incorporated, domiciled, or situated in Argentina. This requirement is in addition to the TP information obligations for cross-border transactions.

General due dates:

Form	Period	Due date
741	First six months of fiscal year	Fifth month following the end of the half-year
741	Second six months of fiscal year	General due date for filing income tax return
867	Full fiscal year	Seventh month following the end of the fiscal year
742	First six months of fiscal year	Fifth month following the end of the half-year
969	Full fiscal year	Fifteen days immediately after the due date for filing the income tax return
743	Full fiscal year	Eighth month following the end of the fiscal year
4501	Full fiscal year (TP report)	Eighth month following the end of the fiscal year

Transfer pricing controversy and dispute resolution

The AFIP has a specialised group that performs TP examinations. This group is part of the *División de Grandes Contribuyentes*, a division of the AFIP that deals with the largest taxpayers. At present, the Argentinian tax authorities investigate TP issues under four main categories:

- In the course of a normal tax audit.
- Companies that undertake transactions with companies located in tax havens.
- Companies that registered any technical assistance agreement, or trademark, or brand name licence agreement with the National Industrial Property Institute.
- Specific industrial sectors such as the automotive, grain traders, oil and pharmaceutical industries.

Controversial issues include, among others, the use of multiple-year averages for comparables or, for the tested party, the application of extraordinary economic adjustments according to the present situation of the country (e.g. extraordinary excess capacity, extraordinary discounts and accounting recognition of extraordinary bad debts).

The audit procedure

The audit procedure must follow the general tax procedure governed by Law 11,683. Transfer pricing may be reviewed or investigated using regular procedures such as onsite examination or written requests. Written requests are the most likely form of audit.

During the examination, the tax authorities may request information and must be allowed access to the company's accounting records. All findings must be documented in writing and witnesses might be required. In the course of the examination, the taxpayer is entitled to request information and the audit may not be completed without providing the taxpayer a written statement of findings. Upon receipt of this document, the taxpayer is entitled to furnish proof and reasoning that must be taken into account for the final determination.

Reassessments and the appeals' procedure

Additional assessments or penalties applied by the *Dirección General Impositiva* (DGI) may be appealed by the taxpayer within 15 working days of receipt of the notification of assessment. The appeal may be made to either the DGI or the tax tribunal. An

unsuccessful appeal before one of these bodies cannot be followed by an appeal before the other, but an appeal before the competent courts of justice may be filed against the findings of either.

If an appeal is made before the DGI or the tax tribunal, neither the amount of tax nor the penalty appealed against need be paid unless, and until, an adverse award is given. For an appeal to be made before the courts of justice, the amount of tax must first be paid (although not the penalties under appeal).

Overpayments of tax through mistakes of fact or law in regular tax returns filed by the taxpayer may be reclaimed through submission of a corrected return within five years of the year in which the original return was due. If repayment is contested by the DGI, the taxpayer may seek redress through either the tax tribunal, or the courts of justice, but not both. Overpayments of tax arising from assessments determined by the DGI may be reclaimed only by action before the tax tribunal or the courts of justice. Upon claim for overpayments of tax, interest is accrued from the time when the claim is filed.

Legal cases

Since the tax reform introduced in 1998, several cases have been and are currently being discussed before the courts. It is expected that the tax courts will address several issues related to TP in the coming years. Following are summaries of some of the TP court cases.

S.A. SIA

The Supreme Court applied Article 8 for the first time in the S.A. SIA case, decided on 6 September 1967. The taxpayer, a corporation resident in Argentina, had exported horses to Peru, Venezuela and the United States. It was stated in the corporation's tax return that these transactions had generated losses because the selling price had been lower than the costs. The tax authority decided to monitor such transactions under the export and import clause, according to the wholesale price at the place of destination. The tax authority concluded that, contrary to what had been argued by the taxpayer, such transactions should generate profits. It based this statement on foreign magazines on the horse business, which explicitly referred to the horses of the taxpayer and the transactions involved in this case.

The Supreme Court maintained that because the evidence on which the tax authority based its argument was not disproved by the taxpayer, it deemed that the tax authority correctly reflected the wholesale price of the horses. As a result, the adjustment was considered valid.

Eduardo Loussinian S.A.

Loussinian S.A. was a company, resident in Argentina, which was engaged in importing and distributing rubber and latex. It concluded a supply contract with a non-resident subsidiary of a foreign multinational. Under this contract, the parent of the multinational group, ACLI International Incorporated (ACLI), would provide Loussinian such goods from early January 1974 up to the end of 1975.

After the contract was agreed, the international market price of rubber and latex fell substantially. However, Loussinian kept importing the goods from ACLI despite the losses. The tax authority argued that there was overcharging under the contract and that Article 8 should be applied in this case. As a result, it considered that the difference between the wholesale price of the goods at the place of origin and the price

agreed on the contract was income sourced in Argentina which Loussinian should have withheld when it made the payments to ACLI. Both the tax court and the court of appeals upheld the tax authority decision.

The Supreme Court said that despite the fact that the purchasing price was higher than the wholesale price, the latter could not be applied to this case to determine the income sourced in Argentina. This was because it considered that Loussinian had rebutted the presumption under which both parties had to be deemed associated, due to this gap between prices.

Laboratorios Bagó S.A.
On 16 November 2006, the members of Panel B of the National Fiscal Court (NFC) issued a ruling in the case Laboratorios Bagó S.A. on appeal – Income Tax. The matter under appeal was the taxpayer's position to an official assessment of the income tax for the fiscal years 1997 and 1998.

Even though the current TP legislation was not in force during those periods (wholesale price method was applicable in 1997 and 1998), the case was closely related to that legislation. Specifically, the ruling addressed issues such as (i) comparability of selected companies, (ii) the use of secret comparables (non-public information) for the assessment of the taxpayer's obligation, and (iii) the supporting evidence prepared by the tax authorities.

Laboratorios Bagó S.A., a pharmaceutical company based in Argentina, exported finished and semi-finished manufactured products to foreign subsidiaries. The tax audit was focused on the differences in prices between the markets involved, both international and domestic.

In this case, the taxpayer argued that, with regard to its export transactions, it only performed 'contract manufacturer' activities, focusing its efforts only on manufacturing. Foreign affiliates performed research and development, advertising, sales and marketing activities, among others.

The tax authorities first confirmed the lack of publicly known wholesale prices in the country of destination. Afterwards, they conducted a survey of other similar companies in Argentina, requesting segmented financial information on export transactions. The main purpose of that request was to obtain the profitability achieved by independent companies in the same industry.

Because the taxpayer's results were below the profitability average of independent companies, the tax authority adjusted the taxable basis for income-tax purposes.

The ruling focused on four specific issues:

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

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

The analysis conducted by the tax authority contained conceptual mistakes that affected the comparability of the transactions (e.g. differences in volume of net sales as well as of export sales, verification of economic relationship or otherwise between the selected companies and their importers, unification of criterion for the different selected companies' allocation of financial information, among others).

It is also remarkable that in this case, the Tax Court accepted the use of secret comparables, being understood as information obtained by the tax authority through audits or other information-gathering procedures.

The taxpayer presented several scenarios and other related evidence that supported its current position.

Eventually, it was the evidence presented by the parties that allowed for the ruling in this case to be favourable to the taxpayer. Specifically, the Tax Court held in this case that under domestic law, the tax authority has a significant burden of proof when adjusting transfer prices. Because the tax authority did not offer enough evidence to support its position, the Tax Court ruled in favour to the taxpayer.

DaimlerChrysler Argentina
The case dealt with export transactions for the fiscal period 1998 (i.e. under the old TP methodology). The members of the Argentinian Tax Court unanimously decided that section 11 of the regulatory decree establishes a 'different' presumption where 'once the business relationship has been proved'; the tax authorities may apply the wholesale price of the country of seller. However, the Tax Court clearly stated that it is not entitled to issue an opinion on the constitutionality of laws unless the Argentinian Supreme Court of Justice had already issued an opinion. Additionally, from the decision of the Tax Court, we understand that there are elements to consider that the comparability standard is not the most appropriate standard for this case.

Based on that interpretation, the crucial element to be determined is whether the business relationship criteria applies to transactions between Mercedes Benz do Brasil, Mercedes Benz Argentina and Daimler Benz AG. Quoting traditional case law and considering the economic reality principle, the Tax Court ruled that wholesale prices effective in Argentina should be applied.

In terms of the price used in the assessment by the tax authorities, the discounts and rebates granted to local car dealers were important elements. The Court adopted a formal approach in this case because it stated that the regulatory decree sets forth that the tax authorities can apply the wholesale price without taking into consideration the impact of the domestic market expenses. As a result, the tax court has not considered that prices in the domestic and foreign market can only be compared if an adjustment is made on the differences in the contractual terms, the business circumstances, functions, and assets and risks in either case. In this situation, the Tax Court has applied a price to a substantially different operation (and therefore non-comparable).

Volkswagen Argentina SA (Fiscal Year 1998)
The case was conceptually similar to DaimlerChrysler Argentina, with the exception that an independent third party acquired products of the local company (VWA), and then sold them, once imported, to *Volkswagen do Brasil* (VWB).

The court's analysis is based on the export contract executed between VWA and the third party. The court considered that certain clauses evidenced the control that VWA and VWB exerted on the third party (i.e. purchase commitments, audit of the costs and expenses of the intermediary, assistance in the import process, among others). As such, the Tax Court concluded that the operations should be considered as having been conducted between related parties, even when the relationship was not economic, based on the principle of economic reality, according to which substance prevails over form.

The Tax Court believes that the Administrative Court ignored Article 8 and applied section 11 of the regulatory decree without giving any reason for not applying the wholesale prices in the country of destination (Brazil) and applying that of the country of seller (Argentina). The procedure followed by the tax authorities would have been appropriate if it had proved why prices informed by the Brazilian tax authorities were not valid, or if it had applied the provisions of Article 8 (i.e. the determination of the factors of results obtained by third parties conducting activities similar or identical to those of the taxpayer).

Volkswagen Argentina (fiscal year 1999)/Aventis Pharma (fiscal year 2000)
Even when the companies belong to different industries, there is a common issue related to the burden of proof when discussing TP issues. The National Tax Court stated that both parties (taxpayer and the tax authorities) shall support their statements on the process and that the quality of the proof is relevant to both parties. The Court considers that the tax authority has not proved its own position, which basically consists of discrediting comparability adjustments carried out by the taxpayers in the TP study.

For example, in case of a selected comparable company with operating losses, the impugnation made by the tax authority is rejected, due to lack of a systematic investigation work, so that disqualification has something to be based on.

As a conclusion, the decision points out the importance of preparing and submitting the TP study because once the taxpayer has met the documentation requirements, the tax authorities shall demonstrate that the analysis performed by the taxpayer is incorrect.

Nobleza Piccardo
In this case, local tax authorities applied the CUP method to analyse the exports of manufactured products using what the tax authorities considered internal comparables (local sales to unrelated customers in a free trade zone). The taxpayer considered that those transactions were not comparable and applied a TNMM.

Again, in this case, the National Tax Court considered that proof was a fundamental element to the final decision because the majority of the judges decided that no comparability was observed in the transactions used by the tax authorities as internal comparables.

Alfred C. Toepfer Internacional
This decision, favourable to the tax authorities, indicates the importance of the 'certain date' of the transactions when dealing with products with publicly known prices (commodities). In this case, as the taxpayer was not able to prove the certain date of the transaction, the tax authorities disregarded the prices applied by the taxpayer and

compared the price of the exported products with the price at the moment of shipping the goods. It is important to mention that the ITL was modified in 2003 to include the position adopted by the tax authorities, but the transactions under discussions referred to the fiscal year before the law amendment.

Boeringher Ingelheim
The Boehringer Ingelheim case, the most elaborated TP decision in Argentina so far, concerns a pharmaceutical company that manufactured and exported medicines as well as imported and distributed finished products. The Tax Court ruled about many aspects, such as the selection of the most appropriate profit level indicator, the preparation of a functional segmentation analysis, the appropriateness of performing country risk adjustments for comparability purposes, the rejection of comparable companies that had transactions with related parties, the burden of the proof, among others.

Regarding the functional segmentation of the financial information of the taxpayer, the Tax Court upheld the AFIP´s criterion that the taxpayer should have used a functionally segmented TP analysis, so that the results reached and the comparables used for the manufacturing function do not get aggregated with those of the distributing function.

In addition, the Tax Court admitted the usage of averaged financial information of the last three years for the tested party. This decision was based on the fact that: (i) local rules do not provide any guidance on this regard, (ii) the tax authorities had accepted the average of financial information of three years for the comparable companies, and (iii) according to the Tax Court, the tax authorities did not provide appropriate arguments to support their position.

Akapol
The National Tax Court rejected the position of the federal tax agency (AFIP) and held that an economic relationship did not exist between two companies that had entered into an exclusive distribution agreement and, as a result, the Argentinian TP rules did not apply to their transactions.

In Argentina, the concept of economic relationship is established by the section added after section 15 of the ITL. The application of that law is determined by the AFIP General Resolution 1122/01 (GR 1122), which provides in Schedule III a list of assumptions that would imply economic relationship.

During a tax audit, the AFIP characterised Akapol S.A.C.I.F.I.A. and a third-party exclusive distributor located in Uruguay (Distributor) as related parties for tax purposes using the list of assumptions from Schedule III and applied a TP adjustment for fiscal year 2001.

The Court rejected the economic relationship presumed by AFIP, holding that the exclusive distribution agreement alone does not provide Akapol with the decision-making power to control the activities of Distributor, a condition that the ITL requires for an economic relationship to exist and so for the TP rules to apply.

Toyota Argentina
On 2 September 2014, Argentina's Supreme Court for the first time passed judgment on a TP controversy related to OECD type regulations. The Supreme Court noted

the strict adherence to the legal principle in TP matters. The material elements of the TP regulations must be established by law and it could not be based on administrative regulations.

It is also implied by the Supreme Court's decision that if the taxpayer properly documents its transfer prices, the burden of proof reverts to the tax authorities. According to the Supreme Court ruling, the tax authorities should provide enough evidence to support its cases in court. It is not enough that it refute the proof provided by the taxpayer, but it must properly back its position as well.

Burden of proof

The general rule is that the taxpayer has the burden of proof, as it is obligated to file a report with certain information related to TP regulations, together with the income tax return. If the taxpayer has submitted proper documentation, the AFIP must demonstrate why the taxpayer's transfer prices are not arm's length and propose an amount of TP adjustment in order to challenge the transfer prices of a taxpayer. Once the AFIP has proposed an alternative TP method and adjustment, it is up to the taxpayer to defend the arm's-length nature of its transfer prices.

Use and availability of comparable information

Availability of comparables

Comparable information is required to determine arm's-length prices and should be included in the taxpayer's transfer pricing documentation. Argentinian companies are required to make their annual accounts publicly available by filing a copy with the local authority (e.g. *Inspección General de Justicia in Buenos Aires*). However, the accounts would not necessarily provide much information on potentially comparable transactions, or operations because they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign comparables.

The tax authorities have the power to use third parties' confidential information.

Use of comparables

To date, there have been several cases where the tax authorities have attempted to reject a taxpayer's selection or use of comparables. Any discussion in this context is focused on the comparability of independent companies, or its condition as independent. In this connection, the tax authority has requested additional information related to the final set of comparables.

Limitation of double taxation and competent authority procedure

Most of the tax treaties for the avoidance of double taxation concluded by Argentina include provisions for a mutual agreement procedure (MAP). In Argentina, a request to initiate the MAP should be filed with the Argentine Ministry of Economy. There are no specific provisions on the method or format for such a request.

No information is available on the number of requests made to the Ministry of Economy. It is understood that the competent authority procedure is not well used in Argentina, as there is no certainty for the taxpayer that the relevant authorities will reach an agreement.

Advance pricing agreements (APAs)
There are no provisions enabling taxpayers to agree on APAs with the tax authorities. There is a binding consultation process available, but it is not commonly used to obtain certainty on TP issues.

Practice
The tax authorities are expected to become more aggressive and more skilled in the area of TP. Transfer pricing knowledge of the 'average' tax inspector is expected to increase significantly, as training improves and inspectors gain experience in TP audits.

As the number of audits increases, some of the main areas being examined include inter-company debt, technical services' fees, commission payments, royalty payments, transfers of intangible property, and management fees.

Liaison with customs' authorities
The DGI and the customs' authority (*Dirección General de Aduanas*, or DGA) are both within the authority of the AFIP. Recent experience suggests that exchange of information between DGI and DGA does occur. The Argentine government issued Decree 2103/2014 establishing a new foreign trade regulatory agency, the 'Monitoring and Tracking of Foreign Trade Transactions Unit' (the Unit), which will monitor and verify the increasing amount of complex foreign trade transactions taking place in and out Argentina. The Unit will allow more direct participation as well as access to information to other Argentine regulatory agencies (i.e. AFIP, Central Bank and Secretary of Commerce are among the members of the Unit). Nevertheless, there is no prescribed approach for the use of certain information of one area in another area (e.g. TP analysis for customs' purposes).

The information that must be provided to the DGA, in relation with foreign trade, is now required in an electronic form. As a result, the DGI could have better and easier access to that information. Also, the DGI has direct access to the customs information of other countries, like Brazil.

Joint investigations
Even though there have been some requests for information from other tax authorities (e.g. Brazil) for specific transactions or companies, there is no regular procedure for joint investigations.

Comparison with OECD Guidelines
Argentina is not a member of the OECD. The tax authorities have generally adopted the arm's-length principle and use as guidance the methodologies endorsed by the OECD Guidelines for TP which give effect to the arm's-length standard.

The Argentinean TP methods are consistent with the OECD Guidelines, with the addition of a specific method for analysing exports of commodities carried out through an international agent. There is no specific priority of methods, except for the method cited for exports of commodities. The most reliable method must be selected and applied. Similarly, the reasons considered for discarding the use of the other methods must be justified. Regional comparable companies are accepted; however, local comparable companies are preferred.

Argentinean legislation establishes the requirement to use interquartile ranges. When the application of any of the specific methods determines the existence of two or more comparable transactions, the median and the interquartile range should be established for prices, amounts of consideration and profit margins. Taxpayers are advised to update comparable company sets annually, in accordance with the expectations of the tax authorities.

Regarding the Tested Party selection, regulations established by the AFIP have stated that the comparability analysis and justification of prices must be made on the basis of the situation of the local taxpayer. In this sense, the local taxpayer must be selected as the tested party in the application of a TNMM.

Finally, it is important to mention that some recent jurisprudence of the National Tax Court established that the role of the OECD Guidelines is to fill in gaps of Argentinian law to make TP regulations as clear as possible.

Argentina

13.

Australia

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Overview

Australia's transfer pricing (TP) laws were comprehensively rewritten in 2013, with a new self-assessment based regime taking effect for income years beginning on, or after, 29 June 2013. The new rules continue to be based upon the arm's-length principle. The law contains specific provisions that require transactions to be disregarded and 'reconstructed' in accordance with hypothetical arm's-length transactions in certain circumstances.

The law prescribes the 2010 Organisation for Economic Co-operation and Development (OECD) Guidelines as relevant guidance materials that must be considered by taxpayers when self-assessing whether they have complied with the rules. Transfer pricing documentation is not mandatory, but it is a necessary prerequisite for establishing a 'reasonably arguable position' (RAP) on any TP matter. Establishing a RAP reduces the penalty rates that may apply if the Commissioner of Taxation (the Commissioner) issues an amended assessment.

The Australian Taxation Office (ATO) actively enforces Australia's TP rules through reviews and audits. The ATO is increasingly focusing on adopting a 'whole of code' approach when considering TP matters, rather than considering TP in isolation, particularly in light of the global focus on base erosion and profit shifting (BEPS). This means that TP issues are often examined in combination with related-international tax issues.

Country	**Australia**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes (but not mandatory)
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border intercompany transactions?	Yes
Does TP legislation apply to domestic intercompany transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes

Australia

Country	Australia
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Prior to filing income tax return
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	Percentage of tax shortfall

Introduction

Australia has had TP legislation in force for several decades. Substantial changes to this legislation were enacted in 2012 and 2013, with a new regime taking effect for income years beginning on, or after, 29 June 2013. The Australian TP rules are based upon the arm's-length principle and are largely consistent with the OECD Guidelines.

The ATO is vigilant in policing taxpayers' compliance with Australia's TP rules and works closely with tax authorities in other jurisdictions and international bodies (such as the OECD) to reduce double taxation, resolve TP disputes and share information.

Australia has a broad network of double tax agreements (DTAs) and tax information exchange agreements.

An advance pricing arrangement (APA) programme is available for taxpayers to apply for unilateral, bilateral or multilateral APAs.

Legislation and guidance

Current legislation: Income Tax Assessment Act 1997 (ITAA 1997) and Taxation Administration Act 1953 (TAA 1953)

The current Australian TP rules are contained within Subdivisions 815-B, 815-C and 815-D of the ITAA 1997. Subdivision 815-B applies to dealings between separate entities, Subdivision 815-C applies to permanent establishments (PEs), and Subdivision 815-D applies to partnerships and trusts. Record-keeping requirements are contained in Subdivision 284-E of Schedule 1 of TAA 1953.

Under Subdivision 815-B, a taxpayer must self-assess whether it has obtained a 'transfer pricing benefit', and if so, it must make an adjustment to negate that benefit. In effect, this means the TP rules can only be applied to increase taxable income in Australia. A taxpayer obtains a 'transfer pricing benefit' from 'conditions' operating between it and another entity (which need not be a related party) in connection with their commercial and financial relations, if the following are satisfied:

- The 'actual conditions' differ from the 'arm's-length conditions', defined as the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.

- The actual conditions satisfy the 'cross border test'.
- Had the arm's-length conditions operated instead of the actual conditions, the amount of the taxpayer's taxable income (or withholding tax [WHT]) would be greater or taxable loss (or tax offsets) would be less.

The law notes that conditions include, but are not limited to, such things as price, gross margin, net profit and the division of profit between the entities. In identifying the arm's-length conditions, it is necessary to use the TP method (or methods) that is 'most appropriate and reliable', having regard to:

- the respective strengths and weaknesses of the possible methods in their potential application to the actual conditions
- the circumstances including the functions performed, assets used and risks borne by the entities
- the availability of reliable information required to apply a particular method, and
- the degree of comparability between the actual circumstances and the comparable circumstances including the reliability of any adjustments to eliminate the effect of any material differences.

This comparability assessment requires a consideration of five comparability factors (which are consistent with the OECD Guidelines), namely the:

- functions performed, assets used and risks borne by the entities
- characteristics of any property or services transferred
- terms of any relevant contracts between the entities
- economic circumstances, and
- business strategies of the entities.

Under Subdivision 815-B, in some circumstances, taxpayers must disregard actual transactions and reconstruct them in accordance with hypothetical arm's-length transactions. Specifically, s815-130 requires taxpayers to consider whether the arm's-length conditions should be identified under a 'basic rule' or one of three exceptions to the basic rule. The basic rule requires the arm's-length conditions to be identified, based on the actual commercial and financial relations (having regard to both the form and substance of the arrangements).

The three exceptions in s815-130 are:

Exception 1: In identifying the arm's-length conditions the form of the commercial and financial relation is to be disregarded to the extent that it is inconsistent with the substance of those relations.

Exception 2: If independent entities would not have entered into the actual commercial and financial relations, but instead would have entered into other commercial or financial relations (which differ in substance from the actual relations), the arm's-length conditions are to be based on the commercial or financial relations that independent parties would have entered into.

Exception 3: If independent parties would not have entered into commercial and financial relations at all, the identification of arm's-length conditions is to be based on the absence of commercial and financial relations (i.e. the actual transaction must be disregarded entirely).

In addition to these core rules, other key features of the TP rules are:

- The arm's-length conditions must be identified in a way so as best to achieve consistency with prescribed guidance materials. The guidance materials currently prescribed for Subdivision 815-B are the 2010 OECD Guidelines.
- Subdivision 815-C requires profits to be attributed to PEs, based on the 'relevant business activity' approach. This permits actual income and expenses to be attributed to a PE, but does not permit the recognition of notional dealings between a PE and its head office. The OECD Model Tax Convention and commentaries are prescribed as guidance materials that must be followed when applying Subdivision 815-C, but only as they read prior to the 2010 version of Article 7. The law enables the Government to make regulations to prescribe additional guidance materials in the future.
- A specific rule addresses the interaction of Australia's TP and thin capitalisation rules (*see the thin capitalisation section below*).

Subdivision 284-E of the TAA 1953 contains optional TP record-keeping requirements. Taxpayers are not able to establish a RAP on TP positions unless they prepare documentation meeting the requirements at, or prior to, the lodgment of their tax return. Therefore, while the preparation of TP documentation is not mandatory, there are penalty implications if contemporaneous documentation is not prepared and the Commissioner makes a TP adjustment (*see Penalties, below, for more detail*). In order to counteract this compliance burden, the Commissioner has outlined a number of simplification measures for taxpayers and transactions considered low-risk (*see Documentation, below, for more detail*).

Previous legislation: Income Tax Assessment Act 1936 (ITAA 1936) and Subdivision 815-A of ITAA 1997

Division 13

The former TP rules were contained in Division 13 of ITAA 1936. While Division 13 has been repealed, it still applies to financial years commencing before 29 June 2013. Transfer pricing matters in years covered by Division 13 remain open for amendment indefinitely. Division 13 applies only at the discretion of the Commissioner and only to increase the tax liability of a taxpayer.

Division 13 dealt with circumstances in which a taxpayer has supplied or acquired 'property' (which is defined very broadly, including for example, services and rights to use intangible property) under an international agreement with another party. As with the current rules, there was no requirement for these parties to be related. In summary, the Commissioner could determine the transfer price in accordance with the arm's-length principle in circumstances where there had been:

- supplies of property for less than arm's-length consideration
- supplies of property for no consideration, and
- acquisition of property for excessive consideration.

Section 136AE addressed international dealings between different parts of the same entity (e.g. dealings between a PE and its head office, or between two PEs of the same entity). The Commissioner was authorised to reallocate income and expenditure between the parties and thereby determine the source of income and the allocation of related expenses.

Subdivision 815-A
Subdivision 815-A of the ITAA 1997 was enacted in September 2012 with retrospective application to income years beginning on, or after, 1 July 2004. Subdivision 815-A ceased to operate for income years beginning on, or after, 29 June 2013. Subdivision 815-A applied to dealings between Australian resident taxpayers and related parties in DTA countries and to Australian PEs of foreign residents of DTA countries.

The Commissioner was permitted to make a determination under Subdivision 815-A when an Australian taxpayer received a 'transfer pricing benefit' in relation to dealings with a related party in a DTA country. A 'transfer pricing benefit' under Subdivision 815-A was defined by reference to the relevant Associated Enterprises or Business Profits Article of the relevant DTA. These Articles typically refer to the profits that have accrued to the parties, so a 'transfer pricing benefit' for the purposes of Subdivision 815-A will arise where the Australian taxpayer's actual profits are less than the profits it would have accrued if it had been dealing wholly independently. The Commissioner was required to have regard to relevant OECD guidance (including the TP Guidelines and Model Tax Convention) when assessing whether a TP benefit has arisen.

Similar to Subdivision 815-B, Subdivision 815-A also contained a specific provision on the interaction of Australia's TP and thin capitalisation rules.

Thin capitalisation
Australia has thin capitalisation rules which apply where an entity's total debt deductions are greater than 2 million Australian dollars (AUD) in an income year. Under Australia's thin capitalisation regime, taxpayers are not permitted to deduct debt related expenses where the debt exceeds certain statutory limits. These rules were tightened for financial years commencing on or after 1 July 2014. Under the new rules, the maximum allowable debt in an income year is the greatest of the following amounts:

- The safe harbour debt amount, i.e. 60% of assets (i.e. a debt to equity ratio of 1.5 to 1), a decrease from 75%.
- The worldwide gearing debt amount, i.e. 100% of the gearing of the entity's worldwide group, a decrease from 120%.
- The arm's-length debt amount, the calculation of which is guided by Taxation Ruling (TR) 2003/1.

The TP laws contain a specific provision (section 815-140) that deals with the interaction of the TP and thin capitalisation rules. Based on this provision, the TP provisions are to be applied first to determine an arm's-length interest rate. The arm's-length rate is then applied to the actual amount of the loan (with interest deductions permitted to the extent the amount of debt is allowable under the thin capitalisation provisions).

Other regulations
Taxation rulings
In addition to the statutory rules referred to above, the ATO has issued various public rulings (in both draft and final form) concerning TP. These both provide the Commissioner's interpretation of the application of the statutory rules and provide guidance on other issues not specifically covered by statute. While final taxation rulings are binding on the Commissioner, they are not binding on taxpayers; however, taxpayers may rely on draft or final taxation rulings for penalty protection.

Two taxation rulings have been issued providing guidance on the interpretation of the new TP rules:

- TR 2014/6 – Application of section 815-130 (i.e. the 'reconstruction' provisions).
- TR 2014/8 – TP documentation requirements.

Practice statements
The ATO provides practice statements to ATO staff on the approaches to be taken in performing their duties. These instructions may outline, for example, procedures for identifying and resolving significant issues, and work practices to be followed in the practical application and administration of the tax laws.

These instructions, known as law administration practice statements (or PS LAs), do not express a precedential ATO view. While taxpayers that rely on a PS LA will remain liable for any tax, they are not liable for any interest or penalties in the event the PS LA is incorrect and the taxpayer makes a mistake as a result.

Three PS LAs have been issued providing guidance on the application of the new TP rules:

- PS LA 2014/2 – Administration of TP penalties.
- PS LA 2014/3 – TP documentation simplification measures.
- PS LA 2015/3 – Process for the application of section 815-130 (i.e. the reconstruction provisions).

Taxation determinations
Taxation determinations are generally shorter than rulings and deal with one specific issue rather than a comprehensive analysis of the overall operation of taxation provisions. Final taxation determinations may be relied upon by taxpayers. Determinations relevant to TP include Taxation Determination TD 2008/20, which provides specific guidance in relation to the interaction of Australia's TP and debt/equity provisions, and Taxation Determination TD 2014/14, which considers the deductibility of 'capital support payments' from an Australian parent company to a subsidiary.

Taxation rulings and practice statements issued under the old law
In addition to the above, there are a number of older taxation rulings, practice statements and taxation determinations that remain applicable for interpretation of the old law. These documents may also have some relevance in interpreting the new law to the extent that they provide coverage of topics that are not addressed in newer ATO guidance and do not conflict with the new law or OECD Guidelines. It is expected that many of these will be revised by the Commissioner in the short-to-medium term as the Commissioner expands upon the range of guidance available for interpretation of the new law.

The taxation rulings, practice statements and taxation determinations that continue to operate are:

- TR 92/11 – Loan arrangements and credit balances.
- TR 94/14 – Basic concepts underlying the operation of the old TP law.
- TR 97/20 – Arm's-length TP methods.

- TR 98/11 – TP documentation and practical issues associated with setting and reviewing transfer prices.
- TR 98/16 – Penalty tax guidelines.
- TR 1999/1 – Intragroup services.
- TRs 2000/16 and 2000/16A – TP and profit reallocation adjustments, relief from double taxation and mutual agreement procedure (MAP).
- TR 2001/11 – Operation of Australia's PE attribution rules.
- TR 2001/13 – Interpreting Australia's DTAs.
- TR 2002/2 – Meaning of 'arm's length' for the purpose of dividend deeming provisions.
- TR 2003/1 – Thin capitalisation and applying the arm's-length debt test.
- TR 2004/1 – Cost contribution arrangements.
- TR 2005/11 – Branch funding for multinational banks.
- TR 2007/1 – Effects of determinations, including consequential adjustments.
- PS LA 2007/8 Treatment of non-resident captive insurance arrangements.
- TR 2010/7 – Interaction of the thin capitalisation provisions and the TP provisions.
- TR 2011/1 – Application of the TP provisions to business restructuring.
- PS LA 2011/1 – Advance pricing arrangement programme. It is expected that this PS LA will be updated within the next 12 months to reflect recent changes to the APA programme such as the introduction of a 'triage' process at the beginning of the APA process (*see Advance pricing arrangements, below, for more detail*).

Penalties

In PS LA 2014/2, the Commissioner sets out his views on how the ATO will issue penalties when it issues an amended assessment in relation to a TP matter. The penalty regime in the event of an amended assessment is outlined below.

- If an entity has a sole or dominant purpose of obtaining a TP benefit and does not have a RAP, the penalty is equal to 50% of the tax shortfall. This is reduced to 25% if the entity can establish that it has a RAP.
- If an entity does not have a sole or dominant purpose of obtaining a TP benefit and does not have a RAP, the penalty is equal to 25% of the tax shortfall. This is reduced to 10% if the entity can establish that it has a RAP.
- The Commissioner has the discretion to remit all or part of a TP penalty. In ordinary circumstances, the Commissioner is likely to exercise discretion where the taxpayer has genuinely made a reasonable attempt in good faith to comply with the law, has made its best efforts to have a documented TP treatment and can satisfy that it did not have a tax avoidance purpose.

In determining whether a position is 'reasonably arguable', it is necessary to determine whether the position is 'about as likely as not, or more likely than not' to be correct. The preparation of contemporaneous TP documentation is a legislated prerequisite for establishing a RAP.

In addition to penalties, which are not deductible, the taxpayer is liable to pay a shortfall interest charge (SIC) on the value of any increase in the tax assessment arising from an ATO adjustment. This interest is deductible. The SIC annual rate is calculated by using the Reserve Bank of Australia's 90-day Bank Accepted Bill rate, plus an uplift factor of 3%. The SIC annual rate was 5.36% for the quarter April – June 2015.

Documentation

Legislative requirements

Transfer pricing documentation is not mandatory; however, as noted previously, taxpayers who do not prepare documentation meeting the requirements of Subdivision 284-E are precluded from establishing a RAP on any TP matter. To meet the requirements, the documentation must:

- be in the possession of, or freely accessible to, the Australian
- be prepared by the time of lodging the tax return
- be in English (or readily convertible to English)
- explain the way in which the taxpayer has applied the Australian TP laws
- explain why the taxpayer's application of the law achieves consistency with the prescribed guidance materials
- allow the following to be readily ascertained:
  - the arm's-length conditions relevant to the matter(s)
  - the method(s) used and comparable circumstances relied upon to identify the arm's-length conditions
  - the result of applying the law in that way (i.e. whether a TP benefit has arisen)
  - for Subdivision 815-B, the actual conditions relevant to the matter(s), and
  - for Subdivision 815-C:
    - the actual profits attributed to the PE and the arm's-length profits attributable to the PE, and
    - the activities and circumstances of the PE (including the functions, assets and risks attributed to the PE).

ATO guidance

The ATO has issued guidance in TR 2014/8 elaborating on the documentation requirements. In this draft guidance, the ATO clarifies that it expects taxpayers to explicitly consider the 'reconstruction' rules in their documentation. The draft guidance also clarifies that the Australian taxpayer must have ready access to the documentation, i.e. it is insufficient for the documentation to be held offshore and available upon request.

TR 2014/8 provides a suggested framework in accordance with which taxpayers should prepare their TP documentation. The framework suggests entities consider five key questions when documenting their transfer pricing:

- Question 1: What are the actual conditions that are relevant to the matter(s)?
- Question 2: What are the comparable circumstances relevant to identifying the arm's-length conditions?
- Question 3: What are the particulars of the methods used to identify the arm's-length conditions?
- Question 4: What are the arm's-length conditions and is/was the TP treatment appropriate?
- Question 5: Have any material changes and updates been identified and documented?

ATO documentation simplification measures

The Commissioner has acknowledged that, while the preparation of documentation is important to demonstrate that taxpayers have self-assessed their compliance with Australia's TP laws, such preparation can be costly for smaller businesses

and unnecessarily onerous for low-risk transactions. Therefore, in PS LA 2014/3 (and associated online guidance *Simplifying Transfer Pricing Record Keeping*), the Commissioner has outlined the circumstances in which taxpayers may rely upon simplified documentation. If a taxpayer is eligible for one of these simplification measures, the Commissioner will not allocate compliance resources or take other compliance action to examine its TP records (beyond reviewing its compliance with the simplification criteria).

The circumstances in which the preparation of 'complete' TP documentation is not necessary are set out below.

To apply the small taxpayer simplification measure, the Australian economic group must:

- not have more than AUD 25 million turnover
- not have related-party dealings involving royalties, licence fees or research and development arrangements
- not have specified service (i.e. any strategic activity contributing significantly to the creation, enhancement or maintenance of value in the group, such as software development and the development of various forms of intellectual property and know-how) related party-dealings exceeding 15% of turnover, and
- not be a distributor.

To apply the distributor simplification measure, the Australian economic group must:

- not have more than AUD 50 million turnover
- not have related-party dealings involving royalties, licence fees or research and development arrangements, and
- not have a three-year weighted average profit before tax to sales ratio less than 3%.

To apply the intragroup services simplification measure, the intragroup services must:

- be no more than AUD 1 million or, if greater than AUD 1 million, intragroup services revenue must comprise no more than 15% of total revenue and intragroup services expense must comprise no more than 15% of total expenses
- not have specified service related-party dealings, and
- not have a mark-up on costs greater than 7.5% for intragroup services expense or less than 7.5% for intragroup services revenue.

To apply the low-level loans simplification measure, the Australian economic group must:

- not have total cross-border loan balances exceeding AUD 50 million during the financial year
- not have an interest rate on the inbound intercompany loan exceeding the Reserve Bank of Australia indicator lending rate for 'small business; variable; residential-secured; term' (which was 6.85% as at March 2015)
- have received the loan in Australian dollars, and
- have paid all associated expenses (e.g. interest expense) in Australian dollars.

In addition, if any of the following conditions are broken in relation to any of the above simplification measures, the taxpayer will be ineligible to use it:

- The taxpayer must not have derived three or more consecutive years of tax losses.
- The taxpayer must not have entered into related-party dealings with entities in 'specified countries' (i.e. jurisdictions considered by the Commissioner to be high risk, such as the British Virgin Islands, Cayman Islands and Jersey).
- The taxpayer must not have undergone a restructure within the financial year.
- The taxpayer must have assessed its compliance with the TP rules. At a minimum, this requires the preparation of a memorandum by a taxpayer outlining its compliance with these criteria. A functional analysis and benchmarking, for example, is not required.

The simplification measures have been introduced for a trial period of three years. The ATO will monitor the results of the simplification measures over this period and will then make a decision on whether to continue, modify, or expand the simplification measures.

Tax return disclosures

Every taxpayer that engages in international transactions with related parties which total more than AUD 2 million (including loan balances) is required to submit an International Dealings Schedule (IDS) with its income tax return.

In Section A of the IDS, details must be provided regarding the nature and dollar value of transactions, the locations of counterparties, the extent to which each type of transaction is covered by TP documentation, the pricing methods applied to each type of transaction, details of any cross-border business restructures involving related parties, and various other questions. The other sections of the IDS require disclosures on other international tax matters including thin capitalisation and controlled foreign companies (CFCs).

The ATO uses information from the IDS to assess a taxpayer's TP risk and to identify candidates for review.

Transfer pricing controversy and dispute resolution

Risk differentiation framework

The ATO uses a risk-differentiation framework (RDF) to assess tax risk and determine an appropriate risk management response. In using this framework, the ATO considers the likelihood of non-compliance (i.e. having a tax outcome that the ATO doesn't agree with) and the consequences of that non-compliance (e.g. in terms of dollars, precedent). Large taxpayers are subject to continuous monitoring by the ATO, for example in the form of pre-lodgement compliance reviews, which require the taxpayer to meet the ATO and disclose material tax issues prior to lodgement of an income tax return. Conversely, smaller taxpayers who are rated lower risk by the ATO may only be monitored periodically.

Risk reviews

The ATO typically uses an approach known as a client risk review (CRR) when undertaking a risk assessment of potential material tax issues including TP. The ATO will examine information such as the taxpayer's IDS, compliance history, latest tax collections, news or media articles and other publicly available information to select candidates for CRRs. A CRR is a review of one or more historical income years for which a tax return has been lodged. The ATO's CRRs have become increasingly intensive in recent years, with more detailed questionnaires and more thorough

analyses in order to equip the ATO with the necessary information to determine whether it should proceed to audit.

Taxpayers receive a risk rating for each of the issues reviewed by the ATO at the completion of the risk review. The ATO may issue an overall TP risk rating or a risk rating for a particular TP issue (or issues). A higher risk rating does not necessarily mean that the company will be selected for audit, but with such a risk rating, the taxpayer is likely, at a minimum, to be placed on a watching brief.

International structuring and profit shifting project
The ATO received specific government funding in the 2013–14 federal budget to conduct a four-year compliance programme focused on BEPS. The programme, known as the international structuring and profit shifting (ISAPS) project, is targeting high-risk areas including CFCs, funding, taxation of financial arrangements (TOFA), thin capitalisation, TP and valuations. The programme has a target of generating approximately AUD 4 billion of tax revenue over the four years.

Audits
An ATO audit is more comprehensive than a risk review. In an audit, the ATO conducts extensive investigations to identify relevant facts and evidence. The ATO has wide-reaching information gathering powers, which provide the Commissioner, or any duly authorised taxation officer, full and free access to all buildings, places, books, documents and other papers for the purposes of ITAA 1936 or ITAA 1997. The Commissioner might also require any person to attend and give evidence or produce any documents or other evidence relating to a taxpayer's assessment.

The law also empowers the Commissioner to require a person to produce documents held outside Australia. Compliance with this latter requirement is not mandatory, but where a taxpayer fails to comply with such a request, the taxpayer may not rely on those documents in the event it wishes to challenge the Commissioner's assessment.

After the ATO has gathered the information it requires, it will develop its position on the matter and will issue a position paper to the taxpayer. The position paper will set out the ATO's views on the characterisation of the taxpayer and related-party dealings, the most appropriate TP method and an economic analysis to apply that method using arm's-length comparable data. The position paper will state the ATO's conclusion on whether it believes an amended assessment should be issued.

The taxpayer is usually offered an opportunity to respond in writing to the ATO's position paper, which would involve correcting any factual errors made by the ATO and, where available, to provide additional information and arguments to counter the ATO's position. After a review of the taxpayer's response, the ATO will issue its final position paper followed by determinations and notices of assessment or amended assessments giving effect to the determinations. The notices of assessment or amended assessment will state when any tax, interest and penalties are 'due and payable'. Usually the due date for payment will be 21 days from the date of the notice, but the Commissioner has the discretion to defer or bring forward the payment time. Any delay in paying the assessments incurs additional interest costs.

Joint investigations
The ATO is actively working with other tax authorities to conduct joint audits of a number of multinationals covering tax issues across multiple jurisdictions.

Statute of limitations
For income years beginning on, or after, 29 June 2013, there is a seven-year time limit for the Commissioner to issue amended assessments. There was no statute of limitations under Division 13, so income years commencing prior to 29 June 2013 remain open to amendment indefinitely.

Revised assessments and the appeals procedure
Australia has a comprehensive objection and appeals' procedure for disputing an amended assessment raised by the Commissioner. Under these provisions, the taxpayer may object to an amended assessment issued by the Commissioner. A taxpayer who is dissatisfied with such an assessment has the later of four years from the date of the original assessment (which, under the self-assessment regime, is usually the date of filing the relevant income tax return) or 60 days from receiving the notice of amended assessment to lodge an objection in writing, setting out the grounds relied upon in support of the claim.

In practice, most TP audits are not completed until more than four years after the original assessment, so in most cases taxpayers are required to object within 60 days of receiving an amended assessment. The Commissioner is required to consider the objection and may either allow it in full, in part, or disallow it. The Commissioner is then required to give notice to the taxpayer of the decision on the objection. A taxpayer dissatisfied with such a decision may either refer it to the Administrative Appeals Tribunal (AAT) for review or refer the matter to the Federal Court of Australia.

Where the notice of assessment includes additional tax for incorrect returns, it is generally prudent to remit the matter to the AAT, which has the discretion to reconsider the level of additional tax imposed and may substitute its own decision for that of the Commissioner. In contrast, on appeal to the Federal Court, that court can only decide whether the Commissioner has made an error in law in imposing the additional tax. If no error of law has occurred, then the penalties will remain unadjusted. Decisions of the AAT may be appealed to the Federal Court, but only on a question of law.

Burden of proof
Under Australian law, the burden of proof in a dispute lies with the taxpayer.

Legal cases
To date, there have only been two completed cases involving the substantive operation of Australia's TP laws. Both of these cases, however, were considered in the context of former Division 13 (i.e. Australia's old TP laws). The details of these two cases are summarised below.

Roche Products Pty Ltd v Commissioner of Taxation (2008)
The case concerned the transfer price of goods acquired by Roche Products (an Australian company) from its Swiss parent. The AAT found that the transfer prices paid by the Australian taxpayer for ethical pharmaceutical products were excessive and made adjustments accordingly. No adjustments were made to the transfer prices of the other product lines.

In its judgment, the AAT made a number of comments that provided an insight into the interpretation of Division 13. They included:

- Transfer pricing methodologies – Although the ruling acknowledged the difficulty in finding available comparable data, and used a uniform gross margin to price the transfers of all pharmaceutical products, the AAT expressed a preference for transactional methods over profit methods in the application of Division 13, such as the profit-based transactional net margin method (TNMM).
- Loss-making companies – In noting the weaknesses of profit methods, the AAT pointed out their tendency to attribute any losses to incorrect TP. The AAT rejected this inference. The ruling accepted the taxpayer's commercial reasons for the losses within one division, despite their occurring over a number of years, and did not order a TP adjustment for that division.
- Annual test – The ruling clearly stated that the Australian income tax law requires that arm's-length prices be determined for each separate year under consideration, rather than a multiple-year average.

Commissioner of Taxation v SNF (Australia) Pty Ltd (2011)
The proceedings concerned an Australian distributor (SNF Australia) purchasing from offshore related parties. For 13 years SNF Australia had no income-tax liability and made trading losses in all years bar two. The Commissioner argued that an arm's-length purchaser would never agree to the prices paid, given the sustained period of losses. In a significant win for the taxpayer, the Federal Court and the Full Federal Court both held that SNF Australia had successfully discharged its burden to satisfy the court that the prices paid to offshore related parties did not exceed arm's-length prices. SNF Australia did this through the application of a comparable uncontrolled price (CUP) method.

The ramifications (for the interpretation of Division 13) of SNF Australia's win in the Full Federal Court included:

- The mere existence of losses, even over a lengthy period, will not necessarily mean that the price paid for products is not arm's length.
- The courts found that the CUP method is the most appropriate method for the application of Division 13 where direct transactional data is available. The courts were willing to accept imperfect comparable data, indicating that the ATO cannot set the bar for comparability 'at an unattainable height'.

The Commissioner's loss in the Full Federal Court provided impetus for the federal government to introduce the new legislation.

Chevron Australia Holdings Pty Ltd v Commissioner of Taxation
As at the date of writing, the Federal Court has heard evidence on another substantive TP matter in Chevron Australia Holdings Pty Ltd v Commissioner of Taxation, but has not yet reached a decision. The matter relates to the pricing of intercompany debt.

Other Australian cases
Most of the other Australian cases have been administrative in character. Summaries of these cases are outlined below:

- *San Remo Macaroni Company Pty Ltd v Commissioner of Taxation* (1999) – allegations that the Commissioner had made TP assessments in bad faith.

- *Daihatsu Australia Pty Ltd v Commissioner of Taxation* (2001) – challenging TP adjustments on the basis that the Commissioner did not exercise his power on a *bona fide* basis.
- *Syngenta Crop Protection Pty Ltd v Commissioner of Taxation* (2005) – request for the Commissioner to provide details of the TP assessments.
- *WR Carpenter Holdings Pty Ltd v Commissioner of Taxation* (2008) – request for the Commissioner to provide particulars of matters taken into account in making TP determinations.

To date, there have not been any cases finalised involving the application of Subdivisions 815-A or 815-B. The Chevron case (which has not yet been decided) will consider Subdivision 815-A.

Limitation of double taxation and competent authority proceedings
In the event that a TP audit results in an adjustment, a taxpayer may suffer double taxation. There are, however, mechanisms available to taxpayers, which may be able to limit the double taxation.

Resident taxpayers
An Australian taxpayer may obtain relief from double taxation; however, the mechanism available depends on whether or not there is a DTA.

Where there is a DTA, a resident taxpayer may present their case to the Australian competent authority. The MAP Article in each of Australia's DTAs enables competent authorities of the relevant countries to meet and consult with each other with a view to seeking to resolve potential double-taxation issues. The MAP does not compel an agreement to be reached and does not relieve the Australian taxpayers from penalties or interest charged by the ATO. Taxation Rulings TR 2000/16 and TR 2000/16A outline the procedures for seeking relief from double tax.

If a foreign tax authority makes a TP adjustment and Australia does not have a DTA with that country, there is generally no mechanism to obtain relief from double taxation. However, the resident taxpayer may pursue domestic relief through the Australian appeals' process.

Non-resident taxpayers
A non-resident party to certain transactions may be able to obtain relief from double taxation under Australia's domestic legislation.

Advance pricing arrangements
A formal APA process is available in Australia. Detailed guidance on the ATO's APA programme is contained in PS LA 2011/1. Matters covered in this guidance include:

- Categorising APAs according to their complexity into simplified, standard and complex APAs.
- ATO APA procedures and processes including the ATO Case Leader role and a detailed project management framework for all APAs.
- The availability of a circuit breaker mechanism in some cases.

Reform
While PS LA 2011/1 remains effective, it is currently being reviewed and modified by the Commissioner and is expected to be substantially revised within the next 12 months. The stated aims of the revisions are to:

- Improve taxpayer experience and better support willing participation.
- Improve bilateral and multilateral engagement.
- Increase efficiency and effectiveness.

The Commissioner is seeking to do this by revising PS LA 2011/1 to reduce 'red tape', streamline processes and practices to improve timeliness and reflect a 'principles-based' approach. Although the revised practice statement is yet to be released, a number of changes – deviating from the process described in PS LA 2011/1 – have already been implemented.

The most significant change has been the introduction of a 'triage' process for all APA/MAP applications. To enable the ATO to review potential APA applications and allocate appropriate resources during the triage process, taxpayers need to provide certain information to the ATO before pre-lodgement discussions can begin.

Another change has been that, with the broadening of the skillset of officers involved on APA cases, there has been a much greater emphasis placed by the ATO on identifying and addressing collateral issues before allowing a taxpayer to enter into the APA programme. These issues are more rigorously investigated by the ATO and may include issues such as the characterisation of the related-party dealings (to determine if withholding tax should apply), the potential applicability of controlled foreign company legislation, the potential application of the general anti-avoidance provisions and dealing with ATO reviews or audits (not in relation to TP) already taking place.

Comparison with OECD Guidelines

The Australian rules are generally consistent with OECD Guidelines. In particular, the comparability factors in the OECD Guidelines are incorporated into the Australian legislation and must be considered by taxpayers in self-assessing their compliance with the TP rules. Further, the 2010 OECD Guidelines are prescribed as guidance materials that taxpayers must consider when selecting the most appropriate and reliable TP method and in preparing documentation meeting the Australian requirements. Future updates to the OECD Guidelines are not automatically incorporated into the Australian rules; however, the government is able to make regulations to prescribe additional guidance materials.

The Australian rules differ from the OECD Guidelines in the following respects:

- The 'reconstruction' provisions in s815-130 arguably apply more widely than the 'exceptional circumstances' contemplated in the OECD Guidelines, and are required to be applied by taxpayers on a self-assessment basis (whereas the OECD Guidelines only contemplate disregarding of actual dealings by a tax authority).
- The provision modifying the TP rules where the thin capitalisation rules also apply has been included to clarify the interaction of the Australian TP and thin capitalisation regimes. In contrast, the OECD Guidelines contemplate that some domestic regimes may not include specific thin capitalisation rules (and therefore the TP rules in those regimes may operate to determine the maximum amount of debt allowable).

- Australia has not endorsed the Authorised OECD Approach for PE profit attribution. The attribution of profits to PEs must therefore be based on attribution of actual income and expenses.

14.

Austria

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Overview

The Austrian transfer pricing (TP) environment has been influenced by the recent developments in international tax law where TP continues to be a focus area, in particular, in light of the work of the Organisation for Economic Co-operation and Development (OECD) concerning the base erosion and profit shifting project (BEPS Project). The initiative of the BEPS project as such has effected the Austrian TP environment, for instance, in the form of increased scrutiny of TP-related issues in the course of Austrian tax audits and an extended discussion on the importance of a thorough value-chain analysis. In addition, the BEPS project requests increased documentation requirements (country-by-country reporting) in order to enhance transparency for tax administrations. It is expected that the BEPS discussion will also impact the regulatory environment in Austria. One measure that has already been introduced in Austria with reference to BEPS is a limitation of the deduction of interest and royalty expenses, if the recipient's respective income is not taxed or is low taxed (for more information, please see 'Legislation and guidance').

The Austrian Transfer Pricing Guidelines (ATPG 2010) introduced by the Austrian Ministry of Finance (MoF) in 2010 aim to facilitate and ensure the application of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) to allow for a dynamic interpretation, i.e. to consider further developments by the OECD. Hence, it is recommendable for companies and permanent establishments (PEs) situated in Austria to review their TP set-up in light of the Austrian provisions stipulated in the ATPG 2010 and from a BEPS's point of view.

Country	**Austria**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	N/A

Austria

Country	Austria
When must TP documentation be prepared?	Contemporaneously, however, at the latest when the tax returns are filed.
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Introduction

As a member of the OECD, Austria subscribes to the principles contained in the OECD Guidelines. In addition, the Austrian MoF published the ATPG 2010 in November 2010 with the intention to facilitate the implementation of the OECD Guidelines in Austria. The publication of the ATPG 2010 had been widely anticipated since they harmonise the tax authorities' approach regarding the assessment of TP cases. Transfer pricing is becoming increasingly important, and this is reflected by the increasing number of tax inspectors specialising in international transactions.

Austria has a broad treaty network with approximately 90 double tax agreements (DTAs) on income in place. In addition to the advance pricing agreements (APAs) in line with the DTA, there is a formal procedure for obtaining unilateral APAs in Austria (for more information, please *see 'Transfer pricing controversy and dispute resolution*').

Legislation and guidance

Statutory rules

Austria has general statutory rules that aim at dealing with TP. Consequently, the statutory authority for addressing TP issues is found in the application of general legal concepts, such as substance over form and anti-avoidance regulations, as well as the application of other regulations to deal with issues such as fictitious transactions, hidden capital contributions and constructive dividends. The requirements to apply the arm's-length principle on inter-company dealings and for adequate documentation of transfer prices are constituted in Article 6 Item 6 Income Tax Act and Articles 124, 131 and 138 Federal Fiscal Code, respectively.

Austrian transfer pricing guidelines

The OECD Guidelines were published in Austria as administrative decrees. Although an administrative decree does not have the force of law, this is nevertheless an important indication of the acceptance of the principles contained in the OECD Guidelines and the approach to TP that the Austrian authorities are likely to adopt.

The ATPG 2010 has been published for the general public; however, they primarily aim at providing guidance to tax inspectors on how to handle TP cases by interpretation of the OECD Guidelines. As a result, the ATPG 2010 does not represent comprehensive guidelines on the determination and documentation of transfer prices, but refers back in many aspects to formerly published opinions of the MoF in connection with specific questions of international tax issues, the so-called Express Answer Services (EAS).

No other binding regulations concerning TP have been published. If, however, guidance is required on a particular TP problem, then a taxpayer may submit the facts of that problem to the Austrian MoF to obtain comment on its legal aspects (an EAS inquiry and EAS reply, respectively). It should be noted that, although the reply of the Ministry is not legally binding, these replies are published in professional journals and are referred to in practice.

The ATPG 2010 consists of five chapters that discuss various issues in connection with TP. In the first chapter, 'Multinational group structures', the legal basis of income allocation, the arm's-length principle and the TP methods on the basis of the OECD Guidelines are set out. Moreover, examples of types of inter-company transactions (e.g. manufacturing, sales, services, various financial transactions) are elaborated on. The second chapter, 'Multinational structures involving permanent establishments', discusses TP issues surrounding PEs. This chapter is strongly influenced by the OECD's Report on the *Attribution of Profits to Permanent Establishments* (also referred to as the 'Authorised OECD Approach' – AOA). The third chapter, 'Documentation requirements', deals with basic principles of TP documentation, and requirements for the documentation of benchmarking studies are explained. The fourth part, 'Transfer pricing audits', discusses TP adjustments imposed by the tax authorities and possible solutions for solving disputes. The fifth chapter, 'Tax structures involving intermediate companies', represents the Austrian tax authorities' focus on combating tax avoidance and tax evasion.

Transfer pricing methods

The acceptable TP methods are consistent with the TP methods presented in the OECD Guidelines:

- Comparable uncontrolled price method (CUP method) – this method evaluates the arm's-length nature of a transaction by direct comparison with the price charged in comparable uncontrolled transactions.
- Resale price method (RPM) – this method evaluates the arm's-length nature of a transaction by reference to the gross profit margin realised in comparable uncontrolled transactions.
- Cost-plus method (CPM) – this method evaluates the arm's-length nature of a controlled transaction by reference to the mark-up realised in comparable uncontrolled transactions.
- Transactional net margin method (TNMM) – this method examines the net profit margin realised on a controlled transaction and compares this with the net profit margin earned by independent entities undertaking comparable transactions. The TNMM operates in a similar manner to the CPM and RPM, and ideally should be applied with reference to the net margin that the tested party earns in comparable uncontrolled transactions.
- Profit split method (PSM) – where transactions are very interrelated, it might be that they cannot be evaluated on a separate basis; under such circumstances, independent enterprises sometimes agree to a form of profit split.

The ATPG 2010 states that the method is to be chosen that leads to the most reliable arm's-length result.

Inter-company services
In line with the OECD Guidelines, the ATPG 2010 stipulates that transfer prices for inter-company services are usually determined by applying the CPM in case a CUP method is not applicable. The ATPG 2010 provides an indicative range of mark-ups between 5% and 15% for routine services. This range shall, however, not be considered as safe harbour rule within which the pricing would not be challenged. For example, in case high value services are provided, ATPG 2010 does not consider a mark-up of 5% as adequate.

Although ATPG 2010 explicitly states that the suggested mark-up range is for guidance only, there is a risk that tax auditors will insist on mark-ups within the above-mentioned range and apply this range without further evaluation of the individual circumstances of the case in question.

Management services
Where the amount of a management charge has been calculated on an arm's-length basis, the management fee would normally be tax-deductible. The following issues should, however, also be considered where management services agreements are being concluded:

- A detailed contract should be drawn up.
- The terms of the agreement should not take effect retroactively.
- Documentary evidence to substantiate the provision of services and its benefits to the recipient should be maintained.

Further, the ATPG 2010 includes a list of intragroup activities that are regarded as shareholder activities, and are therefore non-deductible. These comprise, for example, costs of the management board, costs that concern the legal organisation of the affiliated group and incidental benefits. In contrast, the ATPG 2010 also states a number of management services that generally may be charged, e.g. consulting services concerning the economic and legal affairs of the group company, training and education of the personnel on behalf of the group company and costs for a continuous audit as long as these release the subsidiary from its audit expenses.

The following comments of the Austrian Federal Fiscal Court (*Bundesfinanzgericht*) provided in its recent decision (GZ RV/7101486/2012, 11.07.2014) involving the charging of management fees within a group might be helpful to consider when making intercompany charges:

- The arm's-length nature of inter-company transactions should be tested by the Austrian tax authorities in two steps: (i) reviewing the method applied, and (ii) analysing comparable evidence.
- The selection of the most appropriate method is to be based on an appropriate entity characterisation resulting from the functional and risk analysis.
- In order to consider a service as actually rendered, it is not necessary that the service is provided on-site.
- In case of potential overlap of services provided by two related entities based on contractual provisions, double charge of the services cannot be assumed by the Austrian tax authorities without appropriate investigation (i.e. review of time sheets of the relevant employees).

Inter-company financing
The ATPG 2010 states that the CUP method is the preferred method when testing the arm's-length nature of financial transactions. However, the ATPG 2010 also indicates that a direct comparability of bank terms and conditions will not be given in most cases, as there are fundamental discrepancies between the entrepreneurial objectives of inter-company lending and bank lending. The ATPG 2010 does not offer clear guidance on how the interest rate is to be determined.

The arm's-length nature of inter-company interest rates is generally assessed in accordance with international practice with reference to market interest rates, taking into account the creditworthiness of the borrower, term of the loan, existence of guarantees and other relevant comparability factors. As mentioned, the ATPG 2010 does not consider banks comparable to group financing companies from a strategic perspective.

With respect to cash pooling, the TP methodologies generally accepted in Austria are the same as the TP methodologies generally accepted in establishing the arm's-length interest rates on inter-company loans. The service rendered by the cash pool provider can be remunerated, based on the CPM. If the cash pool provider undertakes additional functions and bears risk, this should be considered in the remuneration. According to the ATPG 2010, the synergies resulting from the cash pool need to be allocated among all participating companies. Therefore, in general, no residual profit should be left at the master company.

The ATPG 2010 sets out that guarantee fees need to be charged when a guarantee was provided, based on economic reasons. If, however, the guarantee fee is provided to establish the creditworthiness of a group company, it needs to be assessed whether the group company was equipped with sufficient equity; if the group company is poorly capitalised, then it needs to be evaluated if it is appropriate to charge a guarantee fee at all.

The ATPG 2010 clearly states that group affiliation is relevant in relation to the borrower's creditworthiness, but do not give a clear understanding in how far this should be integrated in the borrower's rating. Notwithstanding, the arm's-length guarantee fee should be established on a 'separate entity' basis (i.e. borrower and its subsidiaries) and based on the ATPG 2010, bank guarantee fees may be used as comparables, where appropriate. The relevant provisions of the ATPG 2010 are somewhat unclear and in practice, tax auditors apply different interpretations of the ATPG 2010's provisions. Therefore, the pricing of inter-company loans and guarantees should be given careful consideration.

Thin capitalisation
There are no statutory rules on permissible debt to equity (D/E) ratios. As a rule of thumb, D/E ratios of 3:1 would in principle not be challenged by the tax authorities, provided the terms of the debt are otherwise at arm's length. A decision of the Tax Appeals Board (*Unabhängiger Finanzsenat*; now Federal Fiscal Court – *Bundesfinanzgericht*) indicates that even a much higher D/E ratio could be permissible, provided that the ability of the company to pay the interest rates and to repay the loan principal at maturity date are supported by a business plan that is based on realistic assumptions. However, it is not clear whether the Administrative High Court (*Verwaltungsgerichtshof*) will confirm this position. Where, e.g. the interest rate is higher than an arm's-length rate, the consequences are that a deduction would be

denied for the excessive interest, that corresponding amount would be qualified as a constructive dividend and withholding tax (WHT) would also be payable (there is normally no WHT on interest payments to foreign lenders, whether related or unrelated, unless the loan is secured by real estate).

Inter-company licences
In general, the ATPG 2010 requires arm's-length compensation in case intangible assets, both registered and not registered, are provided to a related party. Regarding the definition of intangible assets, it refers to chapter VI of the OECD Guidelines.

The ATPG 2010 considers two factors as important in determining a lower and upper limit of the potential royalty charge. The lower limit of arm's-length royalty charges is represented by the costs incurred by the licensor. It is interesting that the ATPG 2010 implicitly accepts the licensor's costs as an indication of the intangible asset's value. It remains to be seen if they rely on this 'lower limit' in both inbound and outbound licensing transactions. As an upper limit, the licence fee cannot reduce the result the licensee would earn without using the intangible asset under the licence.

If there is a lack of comparables, the PSM could be considered, particularly where both parties own valuable intangibles, in line with the OECD Guidelines. Interestingly, the ATPG 2010 notes that if comparables for royalty charges are not available, controlled intangible transactions within the group that had already been audited by foreign tax authorities can be considered as guidance.

Restriction of interest and royalty deduction
With effect from 1 March 2014, Austrian tax relief is no longer granted for inter-company royalty expenses where the recipient is based in a low-tax jurisdiction or is subject to a special tax regime.

Royalty payments are not tax-deductible for an Austrian company if either the nominal corporate income tax rate in the recipient's state is below 10%, or if the income derived from inter-company royalty payments is subject to an effective tax rate lower than 10% in the recipient's state, due to a special tax regime. Furthermore, the restriction of royalty deductions applies if the recipient is subject to a general, or an individual, tax exemption. If the recipient is not the beneficial owner of the royalty payment, then the beneficial owner is to be regarded.

Cost contribution arrangements (CCAs)
Cost contribution arrangements are, in general, acceptable according to the ATPG 2010. However, the ATPG 2010 sets out specific documentation requirements for such arrangements.

Business restructurings
The chapter in the ATPG 2010 dealing with business restructurings prescribes certain documentation requirements and discusses cases when compensation payments need to be made. The ATPG 2010 contains a non-exhaustive list of questions that should be considered and documented when a business restructuring takes place. The extended documentation requirements list stipulates, for instance, that a pre- and post-restructuring functional analysis of the transformed entity should be prepared.

Permanent establishments (PEs)

Under Austrian tax law, a PE is defined as a fixed place of business where a business is carried out. In particular:

- a place where the management is carried out
- branches, plants, warehouses, purchase and sales' establishments, and other establishments where an entrepreneur or one's permanent representative carries out one's business, or
- construction sites lasting for more than six months.

In general, the Austrian definition of a PE largely corresponds to the definitions as set out in the OECD Model Convention. However, the definition of a PE may differ in individual DTAs.

Although the AOA is not implemented in Austrian law, the ATPG 2010 stipulates that the AOA may serve as an interpretation of the application of DTAs as far as it does not contradict Article 7 of the applicable DTA. Hence, the separate entity approach for PEs has been implemented with some restrictions: Until Article 7 of the version of the OECD Model Convention issued in 2010 is implemented in a DTA, no notional interests, licence fees and lending rates are accepted. Moreover, if an activity of a PE is not part of its main activity, no profit mark-up should be used. In addition, the indirect profit allocation methods are still accepted.

As mentioned, the APTG 2010 covers the subject of PE on the basis of the AOA. In order to create a dependant agent, PE dependency and acting on behalf of the principal is required. The criterion of dependency is satisfied *inter alia* if the agent's activities are performed for merely one principal over a longer period of time. According to the ATPG 2010, a confirmation of independency by the parent company does not disprove the agent's dependency. Regarding the second criterion, a dependant agent PE is created if duties arise for the principal through the agent's conclusion of contracts, even if they are concluded in the agent's name. A formal authority to conclude contracts on behalf of the principal is not required.

Therefore, subsidiaries acting solely for one related company, particularly commissionaires, may create a dependant agent PE in Austria. This is especially crucial after conversions from fully fledged distributors to commissionaires. The ATPG 2010 points out that such conversions will especially be scrutinised if the downsized entity's profit decreases significantly, or if it continues to carry out valuable functions on a service basis.

Penalties

There are no specific TP penalties stipulated in the ATPG 2010. However, TP adjustments have a direct effect on the corporate income-tax base and late payment interest may also be assessed if corporate taxes are not paid by the statutory deadline. If, however, the tax liability relating to past years is increased as a result of a tax audit, interest will be charged on the difference between the tax paid and the final tax assessed. The period for which interest is levied starts from October following the assessment year and lasts for 48 months at a maximum. The interest rate amounts to 2% above the base interest rate. If tax is paid late, a late payment surcharge will be imposed, amounting to 2% of the unpaid amount. An additional surcharge of 1% would be levied if tax is not paid within three months as of the date it has become due,

and an additional 1% in case of late payment of the second surcharge. This surcharge is not tax-deductible, and no supplementary interest will be charged.

In addition, with the amendment of the Tax Offences Act 2010, the regulations for infringement of tax law covering fines and imprisonment have been tightened. According to the Tax Offences Act 2010, fines and imprisonment charges may be assessed in cases of tax evasion and tax fraud. Moreover, fines are assessed on negligent and minor tax offences. Further, a tax offence is not only committed by the perpetrator, but also by anyone who incites another person to commit an offence.

Documentation

According to the ATPG 2010 the taxpayer has to prepare reasoned documentary evidence of the issues that were considered when determining the transfer prices. This documentation should be prepared before any transactions occur using those transfer prices, i.e. documentation is required at the time a transaction takes place. According to information obtained from the Austrian MoF the TP documentation has to be readily available at the point of time of filing the tax return. The TP documentation has to be presented to the tax auditors within a short period of time upon request at the latest.

The two-tier approach to TP documentation (master file/local file) is accepted in Austria. Thereby, the local market conditions should be reflected and special documentation requirements set out in the ATPG 2010 – e.g. on business restructurings – need to be considered. In addition, the ATPG 2010 includes an exemplary list of issues that are to be addressed in the documentation of the functional and risk profile, comprising, for instance, the group structure, production processes, as well as competition and market conditions.

The Austrian tax authorities have gained much experience lately by increasing the number of TP audits. They have formed a strict view on what constitutes a reasonably reliable process for using databases to provide comparable data on arm's-length margins or profits. Critical elements of the search strategy are independence criterion (25% preferred), start-ups, loss-makers, geographic region (EU (27) plus Switzerland, Norway and Ireland are generally accepted), size, consolidated data and intangibles. In line with the increased focus on comparability in the OECD Guidelines' updated chapters I–III, the ATPG 2010 stipulates that each of the five comparability factors needs to be considered in detail. Although the ATPG 2010 does not refer to the nine-step process introduced in the update of the OECD Guidelines, this process is generally considered, required, for preparing benchmarking studies from 2010 onwards.

Similarly to the revised OECD Guidelines, the ATPG 2010 states that the application of interquartile ranges to narrow the range of transfer prices is an internationally accepted approach. By contrast, however, the ATPG 2010 provides for an adjustment to the median if a taxpayer's transfer prices deviate from the acceptable range of transfer prices.

One more recent decision of the Austrian Independent Fiscal Senate (UFSW, GZ RV/2515-W/09) deals with the determination of the arm's-length distribution margin. The Senate reached the following conclusions, which may be extended to benchmarking studies in general:

- Benchmarking analyses, where quantitative screenings are used and an independence rate of only 50% is given, can be applied as a plausibility check, but cannot be relied upon for the determination of transfer prices.
- All financial data on the available and accessible comparables, available at the time of the analysis, should be considered in the benchmarking study.
- The use of the full or the interquartile range of results depends on the quantity and the level of comparability of the potential comparables. A small sample (six companies in the case of the decision) does not meet the requirement of there being a sufficient number of observations for statistical analysis; hence, the full range of results can be used.

Transfer pricing controversy and dispute resolution

Burden of proof

As a matter of principle, the tax authorities carry the burden of proof. If the tax authorities challenge a tax return, the taxpayer does not have to prove the accuracy of the return; rather, the tax authorities would have to prove the contrary. However, based on the fact that tax authorities are entitled to ask for the documentation of TP, if an accurate documentation is not provided, the burden of proof switches to the taxpayer. In addition, in international tax cases, the taxpayer bears a special liability of cooperation *(see 'Tax audit procedures')*.

Tax audit procedures

In Austria, it is not usual for the tax authorities to carry out an audit specifically in respect of transfer prices alone. However, recent experience shows that already at the beginning of a tax audit, inspectors request a description of the TP system in place. Typically, transfer prices represent one major part of a tax audit. If TP or benchmarking studies exist, they have to be provided to the tax auditors. The tax authorities have dedicated experts who are retracing and reviewing the correctness and comparability of such studies.

Selection of companies for audit

The tax authorities aim at auditing companies exceeding certain size thresholds on a three- to five-year basis.

For smaller companies, there are three possible ways for a company to be selected for a tax audit:

- Time – Those companies that have not been audited for an extended period are likely to be selected.
- Industry group selection – Tax authorities might focus on certain industries from time to time.
- Individual selection – Some companies are selected individually, based on 'professional judgement' or exceptional fluctuations in key ratios.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The taxpayer has a general duty to cooperate with the tax authorities, although decisions of the Administrative High Court (*Verwaltungsgerichtshof*) indicate that there is a limit to this duty, insofar as the tax authorities cannot demand impossible, unreasonable, or unnecessary information from the taxpayer.

There also is an increased duty to cooperate where transactions with foreign countries are involved. Under this increased duty to cooperate, the taxpayer has a duty to obtain evidence and submit this to the tax authorities. The possibility of administrative assistance from other (foreign) tax authorities does not suspend the duty of the taxpayer to cooperate with the Austrian authorities.

At the same time, in addition to the taxpayer's duty to cooperate with the tax authorities, in its recent transfer pricing court decision (GZ RV/7101486/2012, 11.07.2014) the Austrian Federal Fiscal Court considered the tax authorities' duty to investigate during a tax audit. The case involved the charging of management fees where the court did not accept the tax authority's approach, which relied on mere assumptions for the assessment of tax without thorough investigation of the facts. This decision shows that the tax authorities are constrained by their duty to investigate the evidence relevant in the context of the transfer pricing method applied by the taxpayer in challenging the inter-company arrangements. The relevant evidence, in this context, should be included in the transfer pricing documentation (*see Documentation section*).

The audit procedure

There is no special procedure for TP investigations, which are seen as part of a normal tax audit. In this procedure, the tax auditors visit the company's premises, interview the relevant company personnel and inspect the company's books and records. As far as TP is concerned, tax inspectors increasingly request a summary of the TP system applied, and ask for the TP documentation.

It should be noted that the conduct of the taxpayer during the tax audit can significantly affect both the outcome of the inquiry and the amount of any adjustment. If the taxpayer is able to maintain an objective approach and can provide good documentary evidence to support the TP scheme in place, they will have a much better chance of defending it against any adjustments proposed by the tax authorities.

Revised assessments and the appeals' procedure

After the end of a tax audit, the tax inspector usually issues a 'list of findings', which is discussed with the company and/or the tax adviser. If the company agrees to the findings, the list forms the basis for the revised assessments covering the audited years. If, however, agreement could not be reached on any particular issues, then the tax office would still issue revised assessments in accordance with the inspector's findings, but the company could file an appeal against the assessments.

If an appeal is filed by the company, it will be heard by the Federal Fiscal Court (*Bundesfinanzgericht*, prior to 2014: Tax Appeals Board). The company may file a further appeal against a decision of the Federal Fiscal Court with the Administrative High Court.

If a DTA exists that contains provisions for mutual agreement procedures (MAPs), it is very likely that these procedures would be used to avoid double taxation. According to information obtained from the MoF, there are only a few cases where such an agreement between the tax authorities involved could not be reached. In such cases or where there is no DTA, settlement could be achieved under the Arbitration Convention (the Convention re-entered into force retroactively as of 1 January 2000). Currently, the Arbitration Convention is applicable between Austria and all other European Union Member States except Croatia. Otherwise, Article 48 of the Austrian Fiscal Code and a decree of the MoF provide unilateral measures to avoid double taxation where no

DTA is applicable. Taxpayers subject to taxation on Austrian-sourced income may file an application for a double taxation relief to the MoF, and it may be granted at the Ministry's discretion.

The competent authority procedure may be initiated by the taxpayer, too. In case no competent authority procedure clause is given under the respective DTA, double taxation may be avoided by administrative assistance proceedings (EC Administrative Assistance Directive and EC Administrative Assistance Act) carried out by the tax authorities.

Advance pricing agreements (APAs)

There has been a formal procedure for obtaining unilateral APAs in Austria since 1 January 2011. The Ministry issued a law that enables taxpayers to ask for binding APAs regarding certain issues in taxation, such as TP. These regulations allow taxpayers for the first time to apply for binding, unilateral APAs in Austria. Bilateral agreements remain possible under the MAP clause of the applicable DTA. Besides applying for binding rulings regarding transfer prices, such applications are also possible for reorganisations and group taxation.

Taxpayers wanting to have a binding ruling must submit a written application, which includes the relevant facts, the critical assumptions as well as a legal assessment of the facts. Administrative fees between 1,500 euros (EUR) and EUR 20,000 will be charged for the processing of the application of such APAs, depending on the company's size.

As a reaction to the initiatives of the OECD and the European Commission to fight aggressive tax planning, the MoF issued a procedural document on approaching the taxpayers' requests for binding APAs in December 2014. The document formalises the existing procedures with respect to the APA applications submitted by multinational companies and contains specific criteria based on which such applications are analysed and reviewed in order to prevent aggressive tax planning: Indications (evidence) of unacceptable tax planning structures (e.g. unusually high remuneration [inter-company payments], intermediary group companies without value-added contributions, low-functional entities in a low-tax countries/'tax havens', non-transparent shareholding structure).

The Ministry of Finance will also consider the economic substance of the activities performed in Austria and may liaise with other countries where relevant.

Although the above-mentioned document represents rather a formalisation of the existing APA practice, it also reduces the room for potential negotiation with the tax authorities during the application process that might have been the case in the past.

Comparison with OECD Guidelines

Austria is a member of the OECD. In our experience, the Austrian MoF is very inclined to follow the positions of the OECD as expressed in the Model Commentary and the various OECD reports (e.g. partnership report, report on the attribution of profits to a PE). The ATPG 2010's stated objective is to facilitate and ensure the application of the OECD Guidelines and to allow for a dynamic interpretation, i.e. to consider further developments by the OECD.

In practical terms, there are certain areas where the Austrian tax authority's interpretation of the OECD Guidelines seems to be stricter and/or more extensive than that of the majority of other countries applying the OECD Guidelines. It is therefore recommendable that special regard be paid to the potential TP implications in Austria in the following areas:

- Inter-company financing.
- Business restructurings.
- PEs.
- Benchmarking studies.

15.

Azerbaijan

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Overview

There are no changes in transfer pricing (TP) legislation over the past year. The TP concept is relatively new to Azeri tax law, although in the pre-tax code legislation there were some limited TP regulations focused principally on circumstances where goods, work, or services were sold at, or below, cost or bartered/transferred without charge.

Country	Azerbaijan
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	N/A – No such requirement
Must TP documentation be prepared in the official/local language?	N/A
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No (general financial sanctions may apply
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Azerbaijan

Introduction

The current TP rules were introduced in the current tax code, effective from 1 January 2001 and have been amended several times since then. These rules mainly focus on the determination of prices on the sale of goods, work, or services, and establish the principle of arm's-length pricing for transactions between related parties and, in certain instances, the approach for making adjustments to transfer prices.

In practice, the tax authorities have limited experience in dealing with TP, mainly making adjustments to taxpayers' profits by disallowing certain deductible costs or challenging interest rates or the markup on services that were not, in their opinion, incurred or charged on an arm's-length basis.

Legislation and guidance

Scope

Under the tax code, 'market price' is defined as the price for goods, works, or services, based on the relationship of demand and supply. A contractual price should be deemed the market price between counterparties for tax purposes, unless the contract or transaction falls under one of the exceptions below.

Under the tax code, the tax authorities may apply market price adjustments majorly in the following cases:

- Barter transactions.
- Import and export operations.
- Transactions between related persons.
- Transactions in which the prices within 30 days deviate by more than 30% either way from the prices set by the taxpayer for identical or homogeneous goods, works, or services.
- Insurance of a property of an entity for the amount exceeding net book value of such property.
- In certain cases monthly rent fee of an immovable property for tax purposes.

Related parties

Persons are considered 'related' in the following cases:

- If one person holds, directly or indirectly, 20% or more of the value, or number of shares or voting rights in the other entity, or in an entity that actually controls both entities.
- If one individual is subordinate to the other regarding official position.
- If persons are under the direct or indirect control of a third person.
- If persons have a direct or indirect control over a third person.

Pricing methods

The tax code lists the following methods for determining the 'market price':

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost-plus (CP) method.

The tax code establishes the priority of pricing methods to be used by the tax authorities to determine market prices, according to which, the CUP method should be used first, before all other methods.

If the determination of the market price is not possible under any of the methods above, the market price should be determined by an 'expert'.

Comparability factors
In determining the market price, the tax authorities are required to take into account usual discounts from, or markups to, prices. In particular, the tax code gives specific circumstances of how the discounts or markups can be caused, such as deterioration of the quality of goods, or the expiry of a product's life.

In addition, the tax code sets out the commonly accepted principle that, for the purposes of determining the market price, only transactions carried out under comparable conditions should be taken into account. In particular, the following factors should be evaluated:

- Quantity (volume) of supply.
- Quality level of goods and other consumption indicators.
- Period within which liabilities should be fulfilled.
- Terms of payment.
- Change of demand for goods (works, services) and supply (including seasonal fluctuations of consumer demand).
- Country of origin of goods and place of purchase or procurement, etc.

In the Profits Tax section of the tax code, there is a separate list of comparability factors which should be looked at to identify borrowings that can be treated as taking place under comparable circumstances. In particular, borrowings should take place in the same currency and be under the same terms and conditions.

Resources available to the tax authorities
Although the arm's-length principle has existed in the tax legislation since 2001, the enforcement of this principle is not common practice. Absence of statistical information for benchmarking purposes and the lack of modern information systems hamper the effective application of TP regulations in Azerbaijan.

Use and availability of comparable information
The tax code provides that comparables for the determination of market prices are to be taken only from 'official and open' information sources. The tax code does not define or specify what sources are considered official and open, but gives examples of such possible sources – databases of authorities in the specific market, information submitted by taxpayers to tax authorities, or advertisements.

In practice, in the majority of tax audits where TP issues have been raised, the tax authorities have relied on information they collect from other similar taxpayers, or directly from alternative producers or sellers of similar goods in the local market (primarily, state-owned concerns). Information published by the State Statistics Committee has not been commonly used.

Occasionally, the Azeri tax authorities undertake extensive data-gathering involving comparables to obtain an in-depth knowledge of specific industry practices and pricing policies. The data obtained from comparables have been used in some cases to make TP adjustments on a single-transaction basis, without regard to overall company profitability or multiple-year data. In that situation, taxpayers have been faced with considerable difficulty in challenging the position, as no specific data is provided on the comparables to allow verification and submission of counter-arguments.

Risk transactions or industries

The types of transactions typically scrutinised by the Azeri tax authorities in tax audits include:

- Sale/purchase of goods, where the supplier is an overseas entity, even unrelated to the taxpayer.
- Provision of centralised head-office services, and technical/management fees.
- Import transactions and recovery of related input value-added tax (VAT).
- Interest rates on inter-company loans.

All industries are subject to the TP regulations in Azerbaijan.

Penalties

There is no separate penalty regime for the violation of TP rules; however, TP adjustments made by the tax authority in the course of a tax audit that would increase the taxable revenue of the taxpayer (e.g. by disallowing the deduction of the costs in relation to excessive pricing levels), may lead to the underpayment of tax.

In case of a successful challenge by the authorities, a penalty of 50% of the underestimated tax may be imposed on the taxpayer. In addition, an interest payment of 0.1% per day also would accrue until the tax is paid in full.

Documentation

There is no statutory requirement in Azeri law that requires TP documentation to be prepared, apart from a general requirement for taxpayers to maintain and retain accounting and tax records, and documents. It is however clear those taxpayers that do not take steps to prepare documentation for their TP systems, in general or for specific transactions, will face an increased risk of being subject to an in-depth TP audit.

Transfer pricing controversy and dispute resolution

Currently, the tax authorities do not have specific procedures in the tax code for conducting separate TP audits. Control over prices is primarily made in the course of tax audits.

Under the tax code, the burden of proof rests with the tax authorities to demonstrate that the price charged by a taxpayer significantly fluctuates from the market price. Unless otherwise proved, prices set by taxpayers are deemed to be the market prices. However, if the documentation requested by the tax authorities is inappropriate or unavailable, then the tax authorities can determine the adequate pricing levels, whereby the burden of proof would be shifted to the taxpayer. Taxpayers have the right to appeal to higher level tax authorities or to court.

So far very few court cases have been related to TP in Azerbaijan.

Currently, there are no procedures in Azerbaijan for obtaining an advance pricing agreements. However, it is possible to obtain a written opinion from the tax authorities on TP issues. Such opinions are not binding.

Currently, there are 42 effective double tax treaties with Azerbaijan. However, there is no experience with the application of the TP provision in those treaties.

Comparison with OECD Guidelines

The Ministry of Taxes has started consultations with the Organisation for Economic Co-operation and Development (OECD) on adopting new, more detailed TP regulations. The general expectation is that the OECD-type guidelines and models will be adopted in Azerbaijan at some point in the future, but the Government has not yet indicated a target date.

16.

Bahrain

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Overview

Bahrain does not currently have specific transfer pricing (TP) guidelines, although it does prescribe the use of the arm's-length principle. Bahrain does not impose corporate tax except on oil companies that face a corporate tax rate of 46%.

Country	**Bahrain**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	No
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	No
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Documentation is not mandatory
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	No specific guidance

Bahrain

Introduction
There is currently no specific legislation regarding TP in Bahrain.

Bahrain has double tax treaties (DTTs) in force with various countries including Algeria, Austria, Belarus, Brunei, Bulgaria, China, Egypt, France, Iran, Ireland, Isle of Man, Jordan, Lebanon, Luxembourg, Malaysia, Malta, Mexico, Morocco, the Netherlands, Pakistan, Philippines, Singapore, Sudan, Syria, Thailand, Turkey, the United States, Uzbekistan and Yemen.

Legislation and guidance
There are no taxes in Bahrain on income, sales, capital gains, or estates, with the exception, in limited circumstances, of businesses (local and foreign) that operate in the oil and gas sector or derive profits from the extraction or refinement of fossil fuels (defined as hydrocarbons) in Bahrain. For such companies, a tax rate of 46% is levied on net profits for each tax accounting period, irrespective of residence of the taxpayer.

There are no specific restrictions in the income-tax law pertaining to payments made to foreign affiliates. There is currently no specific legislation regarding TP in Bahrain.

Penalties
The law is silent on the due date for filing of the final income tax statement. However, an estimated income tax statement must be submitted on or before the 15th day of the third month of the taxable year. Where applicable, a taxpayer may also be required to file an amended estimated income tax statement quarterly thereafter, unless a final income tax statement has been provided.

There is no specific guidance on penalty calculation in the Bahrain income tax law.

Documentation
Bahrain income tax law does not contain a specific documentation requirement.

Transfer pricing controversy and dispute resolution
Given the absence of TP guidelines with specific TP provisions (including delineation of specified TP methods), there are no specific rules regarding burden of proof.

Comparison with OECD Guidelines
Although Bahrain is not an Organisation for Economic Co-operation and Development (OECD) member, it acknowledges the importance of the OECD Guidelines as the international best practice.

17.

Belgium

B

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Overview

The Belgian tax authorities turned their attention towards transfer pricing (TP) in the early 1990s. Belgium has become more aggressive in the field of TP as it has become increasingly aware of the active interest adopted (typically) in the surrounding countries and the risk of seeing Belgium's taxable basis eroded. This focus on TP resulted in the issuing of a Dutch/French translation of the 1995 Organisation for Economic Co-operation and Development (OECD) Guidelines (and the 1996, 1997 and 1998 additions thereto) and of a revenue document that comments on the 1995 OECD Guidelines and serves as an instruction to tax auditors. As of 1 January 2003, the Belgian Government also introduced a new broadened ruling practice aimed at providing foreign investors upfront certainty regarding their ultimate tax bill.

In 2004, further changes to the ruling procedure were made to enhance a flexible cooperation between taxpayers and the Ruling Commission. A specialist TP team has been established and, in 2006, the Belgian tax authorities also installed a special TP investigation squad. Finally, during 2006, the Belgian Government issued a second TP practice note, endorsing the European Union (EU) Code of Conduct on transfer pricing documentation.

Country	**Belgium**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes

Belgium

Country	Belgium
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Upon request
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Adjustment penalties as a percentage between 10%–200%

Introduction

The Belgian Income Tax Code (ITC) did not provide specific rules on inter-company pricing until mid-2004, with the formal introduction of the arm's-length principle in a second paragraph to Article 185 of the ITC.

In addition, the authorities can make use of other more general provisions in the ITC to challenge transfer prices. For example, in some cases where the Belgian tax authorities raise the issue of TP, the general rules on the deductibility of business expenses are invoked. Furthermore, the ITC contains provisions that tackle artificial inbound or outbound profit shifting. These are the so-called provisions on abnormal or gratuitous benefits.

Legislation and guidance

Arm's-length principle

In 2004, Article 185 of the ITC was expanded to include the arm's-length principle in Belgian tax law for the first time. Article 185, paragraph 2 of the ITC allows for a unilateral adjustment to the Belgian tax basis, similar to the corresponding adjustment of Article 9 of the OECD Model Tax Convention.

Deductibility of expenses

General rules

The general rule concerning the deductibility of expenses is contained in Article 49 of the ITC. This Article stipulates that a taxpayer enjoys the presumption of deductibility. The tax authority presumes that the expenditure is incurred for the benefit of the taxpayer and is connected with the taxpayer's business activity. However, the taxpayer has to provide proof of the authenticity and amount of the expenditure. In addition Article 53 (10) demands that the amount of that expenditure must not exceed business needs to an unreasonable extent.

Excessive expenses

As a matter of principle, the tax authorities and courts may not test whether a business decision was expedient. Although the company bears the burden of proof that expenses are necessarily linked with its operations or functions, the authorities have no right to question whether the expenses are useful or appropriate. However, Article 53 (10) of the ITC provides that relief may be denied for any excessive expenses incurred, and this

will be the case if the expense is not reasonable in light of the activities carried out. No case law exists on the application of this article in the context of TP.

Interest payments
Article 55 of the ITC provides that interest paid is a tax-deductible business expense, provided that the rate of interest does not exceed normal rates after taking into account the specific risks of the operation. (*See also section on thin capitalisation.*)

Article 54 of the ITC contains a special rule to the general rule of Article 49 of the ITC. It states that interests and other similar rights, or payments for supplies and services (such as fees for granting use of patents and manufacturing processes) are not considered tax-deductible business expenses if they are made or attributed to taxpayers, resident or having a permanent establishment (PE) in a country whereby they are not subjected to tax or are subjected to a tax regime that is appreciably more advantageous than the applicable tax regime in Belgium. However, the taxpayer can bring proof that the transactions are real and genuine and do not exceed normal boundaries.

In a judgment by the European Court of Justice (ECJ), it was determined that this rule breaches the free movement of capital, written down in Article 49 of the TFEU. The ECJ found that the lack of presumption of deductibility, which is included in the general rule of Article 49 of the ITC, the substantive requirements, which are stricter in Article 54, and the lack of a clear definition of which countries are targeted, make it liable to restrict the free movement of capital.

Even though the Article could be justified by reasons of prevention of tax evasion and preservation of the effectiveness of fiscal supervision and balanced allocation, it was not proportionate. The scope could not be determined with sufficient precision and its application remained uncertain, which made it impossible for the taxpayers to provide evidence of any commercial justification.

In subsequent Belgian cases, the position of the ECJ has been followed, the most recent of which was by the Court of Appeal of Liège on 23 October 2013. The Court followed the ECJ and stated that the prohibition of interest deduction does not stand. The fact that there is a relationship of mutual dependence between payor and payee or that the interest is effectively not taxed or at a much lower rate, does not have an impact on the case.

Abnormal or gratuitous benefits
Article 26 of the ITC provides authority for the taxable profits of enterprises in Belgium to be increased where the authorities can demonstrate that any profit transfers were ‘abnormal or gratuitous benefits’ granted to individuals or companies established in Belgium or abroad. This does not apply if the benefits transferred are subject to (Belgian) tax in the hands of the recipient(s). Although this Article seems to have become obsolete because of the formal introduction of the arm’s-length principle in Belgian tax law by Article 185, paragraph 2 of the ITC, this is not true for situations where the latter Article does not apply. This may, for example, be the case for pure Belgian transactions where the recipient of the benefit is not subject to taxation on the said advantage.

The Belgian ITC does not define ‘abnormal or gratuitous benefits’ and, consequently, the issue has been subject to review in the courts. Case law suggests that ‘abnormal’

refers to 'that which is not consistent with common practice', while 'gratuitous' refers to the fact that a benefit is not granted in the course of the execution of a contractual obligation, or is granted where there is no equivalent consideration (Court of Cassation, 22 September 2011, Belgian Government/Aquaflam NV, F.10.0087.N; Pas. 2011, afl. 9, 2028).

The Belgian legislature inserted in Article 26 paragraph 1 of the ITC the following wording: 'notwithstanding the application of Article 49'. This means that, in case of an internal Belgian situation, the application of Article 26 of the ITC does not exclude the application of Article 49 of the ITC. In other words, even if the abnormal or gratuitous benefit is taken into account for determining the taxable basis of the beneficiary, the tax deductibility of the related expenses can still be denied in the hands of the grantor. This could result in economic double taxation. This provision has come into play as from tax year 2008 and has been ruled to be in line with the Belgian equality principle (Constitutional Court nr 149/2013, 7 November 2013; BS 10 March 2014).

Article 207 of the ITC provides that a Belgian company that receives (directly or indirectly) abnormal or gratuitous benefits from a company upon which it is directly or indirectly dependent, may not use any current year losses or losses carried forward, nor may it apply the participation exemption, investment deduction or notional interest deduction against the taxable income arising from the benefit. In an answer to a parliamentary question (L. Van Campenhout, 2 April 2004), the Belgian Minister of Finance has given a very broad interpretation to this provision by declaring that in the case of received abnormal or gratuitous benefits, the minimum taxable basis of the receiving company equals at least the amount of the benefit. There has, however, been controversial case law which denies the recognition of a minimum taxable basis in those cases where the taxable profit is smaller than the tax losses for a given year (Antwerp Court of Appeal, 6 November 2012; Antwerp Court of first instance 14 January 2014). The previous administrative tolerance under which abnormal or gratuitous benefits received from abroad were not tackled has been abolished as from tax year 2004.

Anti-abuse regulation

Under the Programme Act of 29 March 2012, a general anti-abuse provision was introduced in Belgian tax law, applicable as from tax year 2013 – income year 2012 (with some exceptions). The revised Article 344, §1, of the ITC contains this general anti-avoidance provision. Under the previously applicable general anti-abuse provision, the Belgian tax authorities could reclassify a legal deed (transaction) into a different transaction, provided that both transactions had the same/similar legal consequences. Due to the latter condition, the old rule in most cases proved to be inadequate to recharacterise transactions on the basis that they did not make commercial sense (commercially rational).

The wording of Article 344 §1 ITC now clearly provides that a transaction (in other words a legal action [or a chain of legal actions]) is not opposable towards the tax authorities if the tax authorities can demonstrate that there is tax abuse.

For the purpose of the anti-abuse rule, 'tax abuse' is defined as:

- a transaction in which the taxpayer places himself – in violation with the purpose of a provision of the ITC – outside the scope of this provision of the ITC and whereby the tax advantage is the essential goal of the transaction, and

- a transaction that gives rise to a tax advantage provided by a provision of the ITC, whereby getting this tax advantage would be in violation with the purpose of this provision of the ITC and whereby getting the tax advantage is the essential goal of the transaction.

In case the tax authorities uphold that a transaction can be considered as tax abuse, it is up to the taxpayer to prove that the choice for the legal action or the whole of legal actions is motivated by other reasons than tax avoidance (reversal of burden of proof). In case the taxpayer cannot demonstrate this, the administration can reclassify the transaction, or the whole of transactions into another transaction. The transaction will be subject to taxation in line with the purpose of the ITC, as if the abuse did not take place.

Please note that the extent of this anti-abuse rule is still uncertain. Notwithstanding the fact that the Belgian tax authorities published administrative commentaries on 4 May 2012 (Circular letter Ci.RH.81/616.207) on this anti-abuse rule, no clear examples have been given in this respect. However, in the parliamentary works (DOC 53 2081/016) with respect to this anti-abuse rule, the Belgian Minister of Finance stated that taxpayers will still be free to choose the structure with the lowest tax burden, provided that there is no tax abuse (i.e. provided that there is a commercial rationale for the transaction).

Notional interest deduction

On 22 June 2005, the Belgian tax law on the notional interest deduction was passed.

These rules are intended first to ensure equal treatment of debt and equity funding.

Companies liable to Belgian corporation tax (including Belgian branches of foreign companies) are granted a notional interest deduction equal to the 10-year state bond rate on the equity shown in the company's individual Belgian financial statement. The equity requires slight alteration (e.g. holdings in subsidiary companies [inter alia] are to be trimmed off in assessing the relevant equity figure).Initially the notional interest deduction could be carried forward for a period of seven years in cases where there was no direct tax effect (e.g. in loss situations). However, on 20 July 2012, the Council of Ministers approved the limitation of the carry forward of excess notional interest deduction (NID). According to this law, carrying forward excess NID is no longer possible. As from tax year 2013 (financial years closing between 31 December 2012 and 30 December 2013, both dates inclusive) the existing NID carried forward (as per 31 December 2012) can still be utilised but within certain limitations.

The NID rate is capped at a maximum of 3% (3.5% for small and medium-sized enterprises [SMEs]). For tax year 2015 (accounting years ending between 31 December 2014 and 30 December 2015, both dates inclusive) the NID equals 2.63% (3.13% for SMEs). For tax year 2016 (accounting years ending between 31 December 2015 and 30 December 2016, both dates inclusive) the NID equals 1.63% (2.13% for SMEs).

On 4 July 2013, the ECJ rendered its judgment in the Argenta Spaarbank NV case (C-350/11). The ECJ ruled that the NID rules and, in particular, the refusal to apply the NID to a foreign PE's net assets violates the freedom of establishment.

The Act of 21 December 2013 provides an amendment to the NID legislation in such a way that as of assessment year 2014 (accounting years ending 31 December 2013 or later):

- foreign PEs (located in a treaty country) no longer result in a correction of the NID calculation basis
- the correction occurs at a later stage as the NID calculated on the higher calculation basis must be reduced with:
  - the lower amount of (i) the result of the foreign PE or real estate and (ii) the net asset value (cfr. the definition included in the Act) of the PE or real estate multiplied by the NID rate, if it concerns a PE located in the European Economic Area (EEA)
  - the net asset value of the PE or real estate is multiplied by the NID rate if it concerns a PE or real estate located in a treaty country outside of the EEA.

Confirmed by the Parliamentary draft documents, this would imply that a Belgian company with a loss-making PE no longer loses the benefit of the NID, calculated on the net asset value of the PE based in the EEA.

As concerns the past, the Belgian tax administration confirmed that all pending disputes or new requests will be treated according to the new legislation (Circular letter 16 May 2014). Recent case law, however, stated that the new legislation can only be applied as of assessment year 2016, so that for (older) pending cases no correction for the net assets of a foreign PE or real estate has to be applied (Bruges Court of first instance 9 April 2014; Antwerp Court of first instance 13 February 2015).

Example
A Belgian company realises Belgian profits of 120, the NID related to the Belgian assets amounts to 25. There is an EEA PE with a profit of 50 and net assets resulting in NID of 40. In this case, the total NID would amount to 65. In a second step, the NID would be reduced with 40 resulting ultimately in a Belgian taxable basis of 120 and a NID of 25.

If the NID related to the PE's net assets would amount to 60, the total NID would amount to 85, but would only be reduced with 50 (the branch result). In such a case, the Belgian taxable basis would amount to 120 and the NID to 35.

Entry into force: This proposed rule is applicable as from tax year 2014.

Patent income deduction
On 27 April 2007, the Belgian parliament approved the law introducing a tax deduction for new patent income (PID) amounting to 80% of the income, thereby resulting in effective taxation of the income at the maximum rate of 6.8%.

To benefit from the PID, the Belgian company or branch can exploit the patents owned by it, or licensed to it, in different ways.

A first option available to the Belgian company or branch is to license the patents or extended patent certificates to related and unrelated parties.

Alternatively, the Belgian company or branch can exploit the patents by manufacturing, or having manufactured by a contract manufacturer, products in which

the patents are used and supply the products to related or unrelated customers. It may also use the patents in the rendering of services.

For patents licensed by the Belgian company or branch to any related or unrelated party, the PID amounts to 80% of the gross licence income derived from the patents and patent certificates, to the extent the gross income does not exceed an arm's-length income. The PID applies to variable and fixed patent licence fees as well as other patent income, such as milestone payments.

For patents used by the Belgian company or branch for the manufacture of patented products – manufactured by itself or by a contract manufacturer on its behalf – the PID amounts to 80% of the patent remuneration embedded in the sales price of patented products. In the case of services, the PID amounts to 80% of the patent remuneration embedded in the service fees.

This tax measure is aimed at encouraging Belgian companies and establishments to play an active role in patent research and development, as well as patent ownership. The tax deduction is to apply to new patent income and has come into force as from financial years ending on or after 31 December 2007.

The Act of 17 June 2013 introduced a new rule regarding PID. The rule now states that SMEs can also benefit from the patent income deduction, even if the patents are not developed or improved within a research centre, which forms a branch of activity as mentioned in section 46 § 1, 1, 2° of the Belgian Income Tax Code.

Finally, one should monitor how the OECD's revised nexus approach may impact the existing regulation.

Withholding tax

The law concerning Tax and Financial Measures, dated 13 December 2012 has amended article 228, §3 of the ITC as from the 1 January 2013. Pursuant to a Royal Decree of 4 March 2013, the enactment relating to the professional withholding tax (WHT) obligation on qualifying payments has been delayed to fees paid or made payable as from 1 March 2013. In brief, as a result of this change, a WHT will apply in Belgium on certain payments made by Belgian residents (or a Belgian establishment of non-Belgian residents, as defined for domestic tax purposes) for services provided in Belgium or abroad.

Three conditions have to be met for this so-called 'catch all' provision to apply to a Belgian resident company. First of all there needs to be a cost borne by a Belgian resident company. In a note to debtors of payroll, dating from the 23 July 2014, the tax administration clarified that, in contrast with the text of the law, the obligation only targets payments for services.

Secondly, the cost needs to relate to income that is considered as taxable income under Belgian domestic law.

Lastly, there needs to be an income tax treaty based on which Belgium is allowed to tax or, in the absence of an income tax treaty, the non-resident cannot demonstrate that the income is effectively taxed in its own residence state. The tax administration has provided a template, which could be used by the non-resident to obtain certification by

the tax authorities of its own residence state, confirming that the income is, or will be, effectively taxed.

The tax administration also determined that no tax should be retained on the first sum of 38,000 euros (EUR) per non-resident, per year and per Belgian debtor.

Administrative guidelines

Initial guidelines

On 28 June 1999, administrative guidelines were issued relating to TP. The guidelines are broadly based on the OECD Guidelines. The reason for issuing the guidelines is of a purely 'offensive' nature. The guidelines stipulate that Belgium risks being forced to make corresponding downward profit adjustments if no adequate measures are taken to counterattack aggressive revenue action in other countries.

Although no specific penalty rules are imposed, the guidelines urge tax inspectors to carry out in-depth TP audits where the taxpayer fails to show 'documentary evidence' that efforts have been made to fix arm's-length inter-company prices. Consequently, taxpayers may benefit from preparing a defence file upfront, substantiating their TP methodology. In addition, the guidelines underscore the importance of conducting a proper functional analysis and refer to a list of generic functional analysis questions.

Guidelines on Arbitration Convention

On 7 July 2000, the Belgian tax authorities issued administrative guidelines on the technicalities of applying the Arbitration Convention. The guidelines offer guidance to taxation officers and tax practitioners into how the tax authorities will apply the Convention. It is also an acknowledgement by the Belgian tax authorities of the need to develop an efficient practice to resolve issues of international double taxation.

Guidelines on transfer pricing audits and documentation

Introduction

The Belgian tax authorities published, in November 2006, administrative guidelines on TP audits and documentation.

In light of certain developments, such as the formal set-up of a specialist TP investigation squad and the approved EU Code of Conduct on Transfer Pricing Documentation, the need had obviously arisen in Belgium for an update of the previous TP administrative guidelines and for new guidance, particularly on TP audits and documentation requirements. The 2006 administrative guidelines fill this need and, at the same time, confirm the integration in Belgian tax practice of the EU Code of Conduct on Transfer Pricing Documentation. The Code of Conduct is added as an appendix to the administrative guidelines.

Cases with a higher risk of prompting an audit

The administrative guidelines contain a list of cases (which is not exhaustive) where 'it may be advisable' to check the TP practices. Among the situations listed in the administrative guidelines are transactions with tax havens and low-tax jurisdictions, back-to-back operations, and so-called complex and circular arrangements, as well as situations that are much more frequent (i.e. entities that suffer structural losses, business restructurings or delocalisation and the charge-out of management fees).

Pre-audit meeting
The administrative guidelines acknowledge the fact that an investigation into the TP dealings of a business and the related documentation form a complex whole and are significantly affected by widely diverse company-specific factors. To this end, the administrative guidelines suggest the possibility of holding a 'pre-audit meeting'. The purpose of this pre-audit meeting is to explore, in consultation with the taxpayer, what should be the appropriate scope of the tax audit, what documentation is relevant to the TP investigation, if there is any readily available documentation, etc.

Concept of 'prudent business manager'
As to the question of what proactive effort is required when putting together transfer pricing documentation, the administrative guidelines refer to the concept of a 'prudent business manager' (i.e. given the nature of the transactions that take place between related companies, it is only normal, as a 'prudent business manager', to maintain written documentation that underpins the arm's-length character of the TP applied).

The administrative guidelines list the information that can be prepared to this end.

Flexibility as to the language of the documentation
The administrative guidelines acknowledge the reality that a large part of the transfer pricing documentation may not be available in one of the official languages of Belgium (i.e. Dutch, French, or German). Reasons for this include the multinational character of business, the growing tendency of organising TP studies at a pan-European or global level, or the need to ask a foreign-related company for information.

Inspectors are urged to apply the flexibility they feel 'in conscience' to be necessary when they evaluate the reasons given by the taxpayer for submitting documentation in a foreign language. This applies particularly to pan-European or worldwide TP studies, group TP policies and contracts with foreign entities.

Code of conduct on transfer pricing
The administrative guidelines ratify the standardised and partly centralised approach to TP documentation that is recommended in the Code of Conduct. This also means that concepts such as the 'master-file' and 'country-specific documentation' are now officially introduced into a Belgian context. The resolution of the EU Council on this Code of Conduct is added to the administrative guidelines as an appendix.

The Belgian government is currently looking at the introduction of mandatory TP documentation following Base Erosion and Profit Shifting (BEPS) action 13 and the revised chapter 5 of the OECD Guidelines. As loyal adherent to the OECD Guidelines, Belgium will most likely largely follow the revised chapter 5 of the OECD Guidelines.

Pan-European benchmarks
The administrative guidelines confirm the current practice whereby the use of pan-European data cannot per se be rejected in the context of a benchmark analysis. This may be interpreted more strictly going forward in view of the changed wording in chapter 5 of the OECD Guidelines.

The use of pan-European analyses finds its justification not only in the often-existing lack of sufficient points of reference on the Belgian market, but also in the fact that many multinational businesses prefer to spread the cost of investing in a benchmark analysis over various countries.

Treatment of tax havens
As of 1 January 2010, Belgian companies and Belgian PEs of foreign companies are required to report in their annual tax returns all payments, direct and indirect, to tax havens totalling EUR 100,000 or more.

Within the context of this new provision, tax havens are considered to be:

- countries that have been identified by the OECD as not sufficiently cooperative in the domain of international exchange of information, and
- countries that appear on a list of countries with no or low (less than 10%) taxes.

Payments made, directly or indirectly, to such tax havens and which have not been reported accordingly are not accepted as deductible business expenses. The same applies for payments that have been appropriately reported, but for which the taxpayer concerned has not provided sufficient proof that the payments have been made in the context of real and sincere transactions with persons other than artificial constructions. The latter proof can be provided by all means of evidence as defined in the Belgian ITC.

Accounting guidelines
The Belgian Commission for Accounting Standards (BCAS) has caused some discussion in the accounting and tax field by issuing advice that deviates from current accounting practice. As Belgian tax law, in principle, follows accounting law (unless it explicitly deviates hereof), these evolutions may also impact the TP field. Broadly speaking, the discussion relates to the acquisition of assets for free or below-market value.

Until now, Belgian accounting law basically referred to the historical cost to determine the acquisition value of assets, provided the principle of fair image of the balance sheet is not impaired.

For those cases where the acquisition price is below the fair value the BCAS argued that the difference between the fair value and the acquisition value should be treated as an exceptional profit at the level of the acquiring company. The European Court of Justice however ruled that no exceptional profit should be recognised in the situation where the acquisition occurred below market value (HvJ C-322/12, *GIMLE*, *Pb. C*. 2013, Afl. 344, 34). The advice issued by the BCAS was consequently also removed after this decision. There is however still uncertainties for those cases where no consideration is given by the receiving company as this is not expressly dealt with in the GIMLE case.

Furthermore, in 2009 a Royal Decree introduced additional reporting requirements in statutory and consolidated accounts made under Belgian generally accepted accounting principles (GAAP). The additional reporting requirements cover (i) information on non-arm's-length inter-company transactions and (ii) information on the off-balance-sheet operations that could have an impact on the balance sheet. By ratifying this Royal Decree, the Belgian legislature complied with the content of the European Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006. These accounting rules introduced new burden of proof on the arm's-length character of inter-company transactions. More specifically, since the board of directors and the statutory auditor have to approve and sign these accounts, sufficient evidence should be available to draw conclusions on the arm's-length nature of inter-company transactions. Henceforth, for transactions covered by these accounting rules, TP documentation may prove to be extremely useful or even required to comply with accounting law and to manage directors' liability.

Transfer pricing controversy and dispute resolution

Legal cases

Belgian authorities did not significantly turn their attention to TP until the beginning of the 1990s. Consequently, relatively few important TP cases have taken place in Belgium.

In the first line of cases the tax authority was relatively mild. Although the Court of Cassation determined on 23 February 1995 that the benefit of losses carried forward in a loss-making company is denied where there has been an abnormal transfer of profit from a profitable company to that loss-making entity. It did state that the benefit can only be denied if the transaction was done with the sole intent of avoiding taxation. The tax administration has to consider if there are any other economic justification before denying the benefit.

An example of such an economic justification is the striving for a global group balance. The Court of Appeal of Ghent declared, in a case of 29 April 1999, that quality discounts given to an affiliated company did not constitute an abnormal or gratuitous benefit, since the Belgian company only granted the discounts to compensate the losses suffered by the related company that originated from the buy of spoiled products of the Belgian company. According to the Court the same compensation would have been given between unrelated companies and that the companies were striving for a global group balance.

Another example is a court case by the Court of Appeal of Mons of 3 November 1989. The Court accepted the granting of interest-free loans to a loss-making daughter, as otherwise the group might have faced adverse financial circumstances. In this case the Court also ruled in favour of analysing in detail why certain related-party transactions take place under terms and conditions that might at first glance breach the arm's-length standard. The objective of protecting enterprises in financial distress is still considered a valid justification in recent years. In a number of cases, different courts have accepted that the conditional waiver of a debt by a parent company to one of its subsidiaries does not constitute an abnormal or gratuitous advantage (after proving and fulfilling all the conditions and requirements). Moreover, it is also worthwhile mentioning that Belgium changed its legislation in 2009 with respect to waiver of debts to protect enterprises in financial distress (*see section on 'Debt waiver'*).

However, on 31 January 2012, the Ghent Court of Appeal decided that the waiver of a debt by a Belgian parent company to its Italian subsidiary is to be considered a gratuitous advantage as it was not demonstrated that the Italian subsidiary was confronted with imminent bankruptcy at the time of the waiver. As such, according to the Court the waiver of debt by the Belgian company was not required or necessary.

On 21 May 1997, the Liege Court of Appeal rendered a favourable decision recognising the acceptability of a set-off between advantages of transactions of related parties. In the case at hand, a Belgian distribution entity acquired the contractual rights (from a group affiliate) to distribute certain high-value branded products in the Benelux countries. However, this was subject to the Belgian entity contracting out the distribution of certain dutiable brands to a Swiss affiliate. The Belgian authorities stipulated that the Belgian–Swiss transaction granted abnormal or gratuitous benefits to the Swiss entity. However, it was demonstrated that the transfer of profit potential to a foreign-related party subsequently generated an inbound transfer of profit from

another foreign-related party. The court based its decision on the economic reality in a group context, and the fact that different companies were involved (and so an indirect set-off was made) did not jeopardise the possibility to net the advantages against each other.

The Court of First Instance in Ghent stated on 14 November 2002 that there is a presumption that the accounts give a faithful view of the financial situation of the company; however this presumption can be refuted. Concretely, the case dealt with a situation whereby a Belgian company acquired shares at the book value, which was lower than the market value, thereby creating an advantage for the Belgian company. The tax authority determined that the financial statements did not reflect the reality and that the Belgian company may be tax liable on the basis of Article 24 of the ITC.

In the more recent cases concerning TP, the motto of the Belgian courts has been 'substance over form'. For example, on 10 June 2010, the Court of Cassation issued a decision where it stressed the importance of substance. In its decision, the Court confirmed that management fees paid to a company having neither tangible or intangible assets, nor operational expenses to perform any management services were deemed to be paid to another company, i.e. the effective provider of the management services. Another example is a case of 27 October 2010, where the Antwerp Court of first instance confirmed the priority of the substance principle by rejecting the deduction of certain business expenses related to a seat of management for lack of justification of personnel, offices, central bookkeeping, or archives of the company.

However, if the Court cannot adequately check the substance of the transactions, it could see it as an abnormal or gratuitous benefit. In a case of 12 December 2012, the Namur Court of First Instance rejected the deduction of costs based on invoices, because they were too vague to check the substance of the presentations. Accordingly, the amount of the invoices was added to the taxable profit.

Another example that shows the importance of adequate proof is a court case of 15 May, 2012 by the Ghent Court of Appeal. The case concerned a Belgian company granting interest-free loans to a Polish daughter, stating that they are dependent on the survival of the daughter, which was in difficulty. Normally, this would be an adequate reason; however, the fact that there was no proof stating that the transaction was meant to bring a balance in the group and there was insufficient information to control the sale transactions led the court to determine that the arm's-length balance was not upheld.

Furthermore, on 22 December 2010 the Supreme Court of Belgium published a preliminary ruling based on the request from the Ghent Court of Appeal of 5 October 2010 in the case of *NV Vergo Technics v Belgian State* (No. 5042), which confirmed that the current version of the corporate income tax code that may in some situations still trigger double taxation does not breach the equality principle laid down in the constitution. The Supreme Court recently repeated this case law in a new case of 7 November 2012.

As a member of the European Union, Belgium also has to abide by the case law of the ECJ. On 21 January 2010, in the case SGI v the Belgian state, the ECJ delivered a judgment that clarifies the position of TP rules within the framework of European law. The relevant provision of the Belgian ITC that was considered was Article 26, which

allowed for adjustments in the cases of 'abnormal or gratuitous benefits' granted to a foreign affiliate, but not in a domestic context.

The ECJ found that (a) there was, in principle, a breach of the EU freedom of establishment, but (b) the Belgian legislation was justified as being within the public interest, provided (c) it was proportional. Proportionality in this context means that (i) the expenses disallowed (or income-imputed) are limited to the excess (shortfall) over the arm's-length amount, and (ii) there is a defence of commercial justification. The Court remitted the case back to the Belgian courts to consider whether the way in which the national legislation was applied met the two tests of proportionality.

Tax audit

As noted above, Belgian tax authorities have issued administrative guidelines on TP audits and documentation. Although these guidelines are not legally binding, they play a pivotal role in current (and future) TP audits. In carrying out the audits, the tax authority in Belgium uses a data mining technique in order to determine a risk profile of a taxpayer. The technique sets a number of parameters that are used in assessing the risk profile of a taxpayer. In the course of 2013, 2014 and 2015 there has been a large wave of TP audits conducted to various companies in Belgium.

Burden of proof

In theory, taxpayers must demonstrate that business expenses qualify as deductible expenses in accordance with Article 49 of the ITC, while the tax authorities must demonstrate that profit transfers to an affiliate are 'abnormal or gratuitous benefits'. In practice, however, the tax authorities have actually requested on several occasions that taxpayers demonstrate that the TP methodology adopted is on an arm's-length basis (*see below*).

Since 1997, the tax authorities have scrutinised the deductibility of management service fees in a more stringent way. The taxpayer is required to demonstrate that any services provided are both necessary to the business of the recipient and charged at market value.

Selection of companies for audit

The administrative guidelines published in November 2006 contain a list of cases where it may be advisable to check the TP practices (*see Administrative guidelines section, above*).

Transfer pricing enquiries may also arise in the course of a 'routine' tax audit.

The audit procedure

During the course of an audit, the inspector would normally visit the company's premises. The 1999 administrative guidelines urge tax inspectors to interview as many people as possible including staff with an operational responsibility, to get a fair idea of the functions, assets and risks involved.

The tax audit normally begins with a written request for information. The taxpayer must provide the data requested within (in principle) one month. However, the 2006 administrative guidelines preach flexibility as to this one-month period. Any documentary evidence considered relevant to the audit can be requested and reviewed by the authorities. As to the issue of obtaining information from foreign companies, the approach of the administrative guidelines seems to be more demanding than the OECD

Guidelines. Indeed, the fact that a Belgian subsidiary argues that it did not receive any information from its foreign parent on its TP policy can be deemed to reflect a lack of cooperation.

The 2006 administrative guidelines stimulate companies to have a pre-audit meeting with the authorities to (i) discuss the TP policy carried out with the group, (ii) discuss the level of TP documentation already available, and (iii) avoid having irrelevant questions raised which ask the taxpayer to prepare an unreasonable amount of documents. This focused approach should save a lot of time for the taxpayer as well as the tax authorities.

Revised assessments and the appeals procedure

Since assessment year 1999, new revised assessment and appeal procedures have been introduced. The main features can be summarised as follows:

Once the tax inspector has completed the analysis, any adjustment is proposed in a notification of amendment outlining the reasons for the proposed amendment. The company has one month to agree or to express disagreement. The tax inspector then makes an assessment for the amount of tax which they believe is due (taking into account any relevant comments of the company with which the inspector agrees). Thereafter, the company has six months within which to lodge an appeal with the Regional Director of Taxes. The decision of the Regional Director of Taxes may be appealed and litigated. In a number of circumstances, the intervention of the courts can be sought, prior to receiving the decision of the Regional Director of Taxes.

Additional tax and penalties

Tax increases in the range of 10% to 200% of the increased tax can be imposed.

In practice, discussion has arisen as to whether penalties or increases of tax can be levied in the context of abnormal or gratuitous benefits granted by a Belgian taxpayer. Although conflicting case law exists (e.g. Antwerp Court of Appeal, 17 January 1989), the Antwerp Court of Appeal ruled on 15 April 1993 that by its mere nature, abnormal and gratuitous benefits are always elements that are not spontaneously declared in the company’s tax return and can therefore not give rise to an additional tax penalty.

It is unlikely that this reasoning can be upheld in cases where Article 185, section 2 of the ITC is applicable.

Resources available to the tax authorities

Within the Central Tax Administration, several attempts have been made to improve the quality of TP audits and the search for comparable information. To this end, a specialist transfer pricing team (STPT) was established to ensure coherent application of the TP rules by the tax authorities, with a view to achieving consistency in the application of tax policies.

In short, the mission statement of the STPT is to:

- act as the central point of contact for all tax authorities facing TP matters
- maintain contacts with the private sector and governmental bodies in the area of TP
- formulate proposals and render advice with respect to TP

- take initiatives and collaborate in the area of learning and education, with a view to a better sharing of TP knowledge within the tax authorities, and
- take initiatives and collaborate with respect to publications that the tax authorities have to issue with respect to TP.

In addition to creating the STPT, in 2006, the Belgian tax authorities also installed an experienced special TP investigation squad (special TP team) with a twofold mission:

- Build up TP expertise to the benefit of all field tax inspectors and develop the appropriate procedure to conduct tax audits in this area according to the OECD Guidelines.
- Carry out TP audits of multinationals present in Belgium through a subsidiary or branch.

This special TP team has recently been supplemented with more audit teams focusing on TP and hence significantly expanding the reach of TP audits.

Use and availability of comparable information

Use

As indicated above, Belgium, in its capacity as an OECD member, has adopted the OECD Guidelines. Comparable information could, therefore, be used in defending a pricing policy in accordance with the terms of the OECD Guidelines.

On 22 July 2010, the OECD approved and published revisions of Chapter I-III of the OECD Transfer Pricing Guidelines. One of the most significant changes in this respect was the removal of the hierarchy between traditional methods and profit-based methods in favour of the 'most appropriate method' rule. This means that in principle, all the authorised OECD methods now rank equally. In addition, higher standards of comparability are advocated. It is expected that the Belgian tax authorities will be using these new guidelines in evaluating taxpayers' transactions upon tax audits.

Availability

The search for comparables relies primarily upon databases that provide financial data on the major Belgian companies. These databases provide comprehensive annual financial data, historical information and information on business activities, all of which is largely extracted and compiled from statutory accounts.

In addition, the Belgian National Bank maintains a database that contains all statutory accounts. Entries are classified according to NACE (the Statistical Classification of Economic Activities in the European Community) industry code (i.e. by type of economic activity in which the company is engaged).

Information on comparable financial instruments (such as cash-pooling, factoring, etc.) can be obtained from banks. This information (e.g. market interest rates) can then be used to support or defend a TP policy.

The 1999 administrative guidelines acknowledge that Belgium is a small country, so sufficient comparable Belgian data may be difficult to obtain. Consequently, the use of foreign comparables is accepted, provided proper explanation can be provided as to the validity of using surrogate markets. The 2006 administrative guidelines reconfirm that pan-European data cannot *per se* be rejected in the context of a benchmark analysis.

This may be interpreted more strictly going forward in view of the changed wording in Chapter 5 of the OECD Guidelines.

Risk transactions or industries

Generally, there are no industry sectors which are more likely to be challenged than any other, and, since there are no excluded transactions, all transactions between related companies may be under scrutiny.

Debt waivers

According to Article 207 of the ITC, in some circumstances a Belgian company receiving abnormal or gratuitous benefits, whether directly or indirectly, is not allowed to offset among others, current year losses or losses carried forward against these benefits. The circumstances in which this applies are those where the company receiving the benefits is directly or indirectly related to the company granting such benefits. This rule is being used stringently in cases where a loss-making company benefits from a debt waiver. In these circumstances, the waiver could be treated as an abnormal or gratuitous benefit, although certain court cases (and also rulings) confirm the acceptability of intragroup debt waivers under particular circumstances.

In the beginning of 2009, however, the Belgian administration introduced a Continuity Act, which assists companies with judicial restructuring in a court of law. The Act provides, among other things, a tax relief for a waiver of debt on both the creditor and debtor side. If a creditor waives debts according to the judicial restructuring procedure, the debtor's profit resulting from the debt reduction granted by the creditor should remain tax-exempt and the creditor's expenses resulting from waiving the debt will remain tax-deductible within Belgium. In this respect, the Act modified section 48 of the ITC, which now explicitly states that, following approval by the court, expenses incurred due to a waiver of debt will qualify as tax-deductible. Similarly, (exceptional) profits are tax-exempt for the company receiving the waiver.

Permanent establishments – transactions with head office

The tax rules and administrative practices can be summarised as follows.

It is acceptable that, for tax purposes, a 'contractual' relationship exists between a head office and its permanent establishment (PE). Hence, the arm's-length principle applies to most transactions between the head office and the PE, such as the transfer of goods and the provision of services based on the separate entity approach. It is accepted that 'notional profits' can arise from internal transfers and that, in accordance with this treatment, these might be subject to taxation before any profit is actually realised by the enterprise as a whole.

Services

During a tax audit, particular attention would be paid to payments such as management fees or technical support fees to establish whether these payments should actually have taken the form of dividends.

Advance Pricing Agreements (APAs)

Unilateral

As of 1 January 2003, the Belgian Government introduced a new ruling practice that seeks to increase upfront legal certainty for investors, while taking into account national and international tax standards.

Under the new regime, a ruling is defined as an 'upfront agreement', which is a legal act by the Federal Public Service of Finance in conformity with the rules in force with respect to the application of law to a specific situation or operation that has not yet produced a tax effect.

Previously, a taxpayer could apply for a ruling only in a limited number of cases. Under the revised rules, a taxpayer may apply for a ruling in all cases, unless there is a specific exclusion. Although the Ministry of Finance acknowledges that it is impossible to provide a comprehensive list of all excluded topics, the new ruling practice nevertheless explicitly excludes some ruling categories to demonstrate the open nature of the ruling system. To this end, a specific Royal Decree confirming the exclusions was published in January 2003.

A taxpayer may not apply for a ruling involving tax rates, computations, returns and audits; evidence, statutes of limitation and professional secrecy; matters governed by a specific approval procedure; issues requiring liaison between the Ministry of Finance and other authorities, whereby the former cannot rule unilaterally; matters governed by diplomatic rules; penalty provisions and tax increases; systems of notional taxation as for instance used in the agricultural sector; and tax exemptions.

In 2004, further changes to the ruling procedure were made to enhance a flexible cooperation between taxpayers and the Ruling Commission. At the same time, the ruling procedure itself has been rendered more efficient. These changes took effect 1 January 2005.

The provisions of double taxation treaties fall within the scope of the new ruling practice and, therefore, the Belgian competent authority is involved in the preparatory phase of making the ruling decision to ensure consistency of the decisions of the Ruling Commission in this respect.

Summaries of the rulings are published anonymously in the form of individual or collective summaries. The rulings are published at the Government's website, unless a foreign taxpayer is involved and the treaty partner has rules preventing publication. In such cases, approval to publish the ruling is requested.

Under the revised ruling practice, the use of prefiling meetings is encouraged. A request for an advance ruling can be filed by (registered) mail, fax, or email. The Ruling Commission must confirm receipt of a request within five working days. Subsequently, a meeting is organised allowing the Ruling Commission to raise questions and the applicant to support its request. Recent experiences have demonstrated the effectiveness of the Commission and its willingness to accommodate, within the borders of the national and international legal framework, the search by the taxpayer for upfront certainty. Although there is no legally binding term to issue a ruling, it is the Ruling Commission's intention to issue its decision within three months (counting as from the submission of the formal ruling application). In most cases, this three-month period is adhered to.

Bilateral/multilateral
Under the new ruling practice, taxpayers may be invited to open multilateral discussions with other competent authorities. These issues are dealt with, case by case, according to the relevant competent authority provision as stipulated in the tax treaty.

Recent experience shows that the Belgian tax authorities are also promoting bilateral or multilateral agreements and that they take a cooperative position for realising such agreements.

Competent authorities
On 27 November 2006 the United States and Belgium signed a new income tax treaty and protocol to replace the 1970 income tax treaty. This new treaty and protocol entered into force on 28 December 2007. The new treaty introduces an innovative binding arbitration procedure in the context of the mutual agreement procedure. Indeed, when the competent authorities are unable to reach an agreement, the case shall be resolved through arbitration within six months from referral. In this type of arbitration, each of the tax authorities proposes only one figure for settlement, and the arbitrator must select one of the figures ('baseball arbitration').

Anticipated developments in law and practice
Practice has shown a significant increase in TP audits in Belgium as well as in the number of people carrying out TP audits. This trend is expected to continue.

Within that framework, the importance of having available upfront TP documentation will only increase.

Careful attention needs to be given to the reports issued within the framework of the BEPS Action Plan and how these will be adopted in the international and Belgian tax practice.

Liaison with customs authorities
Although it is possible for an exchange of information to take place between the income tax and customs' authorities, this rarely happens in practice.

Joint investigations
A facility exists for the Belgian tax authorities to exchange information with the tax authorities of another country. According to Belgian law, such an exchange must be organised through the Central Tax Administration. A large number of bilateral treaties have been concluded to facilitate this process.

The 1999 administrative guidelines also consider the possibility of conducting joint investigations with foreign tax authorities.

Belgium has already been involved in several of these multilateral audits.

Thin capitalisation
The arm's-length principle applies to financing arrangements between affiliated parties. Article 55 of the ITC provides that interest paid is a tax-deductible business expense, provided that the rate of interest does not exceed normal rates, taking into account the specific risks of the operation (e.g. the financial status of the debtor and the duration of the loan).

In addition, note that related-party loans from shareholders or directors of a Belgian borrowing company are subject to specific restrictions.

In the past, Belgian tax law did not have a general thin-cap rule. A special thin-cap rule only existed for interest payments or attributions to (real) beneficiaries taxed at low rates on that interest. This was the so-called 7/1 debt-equity (D/E) ratio.

The Programme Acts of 20 March and 22 June 2012 replace the 7/1 rule with a new rule introducing a (general) 5/1 D/E ratio. For the purposes of the thin-cap rule, equity is defined as the sum of the taxed reserves at the beginning of the taxable period and the paid-up capital at the end of the taxable period. For the purposes of this new rule, certain non-taxed reserves are deemed to be taxed reserves. It regards inter alia certain tax-free reserves created upon a merger/division (including as a result of merger goodwill).

The below loans are captured by the thin cap rule:

- All loans, whereby the beneficial owner is not subject to income taxes, or, with regard to the interest income, is subject to a tax regime that is substantially more advantageous than the Belgian tax regime
- All intra-group loans (whereby ‘group’ should be interpreted in accordance with section 11 of the Companies Code).

Bonds and other publicly issued securities are excluded, as are loans granted by financial institutions. The new thin-cap rule is not applicable to loans contracted by (movable) leasing companies (as defined by section 2 of Royal Decree no. 55 of 10 November 1967), to companies whose main activity consists of factoring or immovable leasing within the financial sector and to the extent the funds are effectively used for leasing and factoring activities, and to loans contracted by companies primarily active in the field of public-private cooperation.

The new Programme Act of 22 June 2012 has made some amendments to the thin-cap rule in order to safeguard companies that have a centralised treasury function in Belgium. The amendments introduce netting for thin-cap purposes for companies responsible for the centralised treasury management of the group. These companies are allowed to net all interest paid to group companies with all interest received from group companies, insofar the interest is paid/received within the context of a framework agreement for centralised treasury management. In cases where the 5/1 D/E ratio has been exceeded, only net interest payments (of the higher amount) will be regarded as non-tax-deductible business expenses. Centralised treasury management is defined as management of daily treasury transactions, or treasury management on a short-term basis (e.g. cash pools) or, exceptionally, longer term treasury management. In addition, in order to qualify for the exemption, the treasury company should set up a framework agreement under which the group companies clarify the treasury activities and the financing model applicable to their group.

18.

Brazil

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Overview

As is widely known, Brazil's transfer pricing (TP) rules do not adopt the internationally accepted arm's-length standard. Instead, Brazil's TP regulations provide the use of statutory fixed margins to derive a benchmark ceiling price for inter-company import and minimum gross income floors for inter-company export transactions. While incorporating these transaction-based methods, Brazilian TP rules excluded profit-based methods, such as transactional net margin method (TNMM) or profit split method (PSM). In addition, there are many controversial legal issues that have been disputed by taxpayers and tax authorities, and as a result the tax authorities have been imposing tax assessments against many taxpayers.

Brazilian taxpayers endeavour to prepare TP documentation that is acceptable under Brazilian TP rules, while testing transactions performed at prices determined within the context of TP policies prepared with observance of international standards. Within this context, it has been a challenge for the entities operating in Brazil to comply with local rules and at the same time avoid double taxation issues.

Therefore, while the definition of the best approach to deal with TP issues in Brazil is key in order to mitigate potential double taxation issues, the implementation of the defined strategy requires as much care in order to avoid unexpected results.

In view of the substantial double taxation and documentation burdens, several international chambers of commerce and multinational companies have lobbied for changes to the current regulatory framework, in order to align Brazil's TP rules with international standards including the adoption of the arm's-length principle. This effort has so far been unsuccessful.

Country	**Brazil**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes

Brazil

Country	Brazil
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	No
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Usually June 30
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Based on deemed tax deficiencies

Introduction

From the outset, Brazil's TP rules, which took effect on 1 January 1997, have been very controversial. Contrary to the Organisation for Economic Co-operation and Development (OECD) Guidelines, US TP regulations, and the TP rules introduced by some of Brazil's key Latin American trading partners such as Mexico and Argentina, Brazil's TP rules do not adopt the internationally accepted arm's-length principle. Instead, Brazil's TP rules define maximum price ceilings for deductible expenses on inter-company import transactions and minimum gross income floors for inter-company export transactions.

The rules address imports and exports of products, services and rights charged between related parties. The rules also cover inter-company loans, and all import and export transactions between Brazilian residents (individual or legal entity) and residents in either low-tax jurisdictions (as defined in the Brazilian legislation) or jurisdictions with internal legislation that call for secrecy relating to corporate ownership, regardless of any relation.

Through the provision of safe harbours and exemptions, the rules were designed to facilitate the monitoring of inter-company transactions by the Brazilian tax authorities.

Since the Brazilian rules do not adopt the arm's-length principle, multinational companies with Brazilian operations have to evaluate their potential tax exposure and develop a special TP plan to defend and optimise their overall international tax burden. From the outset, planning to avoid potential double taxation has been especially important.

Legislation and guidance

Rules regarding imports of goods, services or rights

Deductible import prices relating to the acquisition of property, services and rights from foreign-related parties should be determined under one of the following Brazilian methods:

Comparable independent price method (PIC)

This Brazilian equivalent to the comparable uncontrolled price (CUP) method is defined as the weighted average price for the year of identical or similar property,

services, or rights obtained either in Brazil or abroad in buy/sell transactions using similar payment terms. For this purpose, only buy/sell transactions conducted by unrelated parties may be used. The use of the taxpayer's own transactions with third parties for purposes of applying this method will be acceptable only to the extent the comparable transactions are equivalent to at least 5% of the tested transactions; if necessary, transactions carried out in the previous year can be considered to reach this percentage.

Resale price less profit method (PRL)
The Brazilian equivalent to the resale price method (RPM) is defined as the weighted average price for the year of the resale of property, services or rights minus unconditional discounts, taxes and contributions on sales, commissions and a gross profit margin determined in the tax legislation. As of 1 January 2013, a 20% gross profit margin is required for industries/sectors in general, calculated based on the percentage of the value imported over the final resale price. For the following industries/sectors a different mark-up is required:

Sectors where a 40% profit margin is required:

- pharma chemicals and pharmaceutical products
- tobacco products
- optical, photographic and cinematographic equipment and instruments
- machines, apparatus and equipment for dental, medical and hospital use, and
- extraction of oil and natural gas, and oil derivative products.

Sectors where a 30% profit margin is required:

- chemical products
- glass and glass products
- pulp, paper and paper products, and
- metallurgy.

These margins are applied in the same way for imports of products for resale or for inputs to be used in a manufacturing process. In applying the PRL, a Brazilian taxpayer may use their own prices (wholesale or retail), established with unrelated parties in the domestic market.

Until 31 December 2012, the PRL method was calculated considering a margin of 20% applicable to products for resale, and if value was added before resale the profit margin was increased to 60%, calculated based on the percentage of the value imported over the final sales price.

Production cost plus profit method (CPL)
This Brazilian equivalent of the cost plus (CP) method is defined as the weighted average cost incurred for the year to produce identical or similar property, services, or rights in the country where they were originally produced, increased for taxes and duties imposed by that country on exportation plus a gross profit margin of 20%, and calculated based on the obtained cost.

Production costs for application of the CPL are limited to costs of goods, services, or rights sold. Operating expenses, such as research and development (R&D), selling and

administrative expenses, may not be included in the production costs of goods sold to Brazil.

Quotation price on imports method (PCI)
This new Brazilian method, introduced by Law 12715/12, must be applied to test imports of commodities that have a quote in a commodities' exchange, as of 2013. Based on this method, taxpayers shall compare the transaction value with the average quote of the respective commodity involved, adjusted by an average market premium, in the date of the transaction. In the case of transactions involving commodities that do not have a quote in a commodities' exchange, taxpayers may choose to test the prices in import transactions, based on information obtained from independent sources, provided by internationally recognised institutes involved in researches of specific sectors.

In the event that more than one method is used, except when the use of the PCI method is mandatory, the method that provides the highest value for imported products will be considered by the Brazilian tax authorities as the maximum deductible import price. This is intended to provide taxpayers with the flexibility to choose the method most suitable to them. The Brazilian rules require that each import transaction be tested by the parameter price determined using one of the three methods, as applicable to the type of transaction (this also applies to export transactions).

If the import sales price of a specific inter-company transaction is equal to, or less than, the parameter price determined by one of the methods, no adjustment is required. Alternatively, if the import sales' price exceeds the determined parameter price, the taxpayer is required to adjust the calculation basis of income tax and social contribution.

The aforementioned excess must be accounted for in the retained earnings account (debit) against the asset account or against the corresponding cost or expense if the good, service or right has already been charged to the income statement.

Until 2012 one of the most controversial issues raised with regard to import transactions was the treatment of freight and insurance costs, as well as Brazilian import duty costs, for purposes of applying the Brazilian TP rules. Before the changes introduced for 2013 onwards, the TP law considered freight and insurance costs and the Brazilian import duty costs borne by the Brazilian taxpayer as an integral part of import costs (i.e. the tested import price). According to the regulatory norms published in November 2002, taxpayers could compare a parameter price calculated under the CPL or PIC methods with an actual transfer price that included or excluded freight and insurance costs as well as Brazilian import duty costs borne by the Brazilian taxpayer. Meanwhile, for testing under the PRL, freight and insurance costs and Brazilian import duty costs borne by the Brazilian taxpayer should be added to the actual transfer price.

As of 2013, taxpayers are no longer required to include customs' duty in the tested price as well as freight and insurance contracted with third parties, provided such third parties are not located in low-tax jurisdictions or benefit from privilege tax regimes.

Rules regarding exports of goods, services and rights
In the case of export sales, the regulations provide a safe harbour whereby a taxpayer will be deemed to have an appropriate transfer price with respect to export sales when the average export sales' price is at least 90% of the average domestic sales' price of

the same property, services, or intangible rights in the Brazilian market during the same period under similar payment terms. When a company does not conduct sales' transactions in the Brazilian market, the determination of the average price is based on data obtained from other companies that sell identical or similar property, services, or intangible rights in the Brazilian market. When it is not possible to demonstrate that the export sales' price is at least 90% of the average sales' price in the Brazilian market, the Brazilian company is required to substantiate its export transfer prices, based on the parameter obtained using one of the following Brazilian methods:

Export sales price method (PVEx)
This Brazilian equivalent of the CUP method is defined as the weighted average of the export sales' price charged by the company to other customers or other national exporters of identical or similar property, services, or rights during the same tax year using similar payment terms.

Resale price methods
The Brazilian versions of the RPM for export transactions are defined as the weighted average price of identical or similar property, services, or rights in the country of destination under similar payment terms reduced by the taxes included in the price imposed by that country and one of the following:

- A profit margin of 15%, calculated by reference to the wholesale price in the country of destination (wholesale price in country of destination less profit method, or PVA).
- A profit margin of 30%, calculated by reference to the retail price in the country of destination (retail price in country of destination less profit method, or PVV).

Purchase or production cost-plus taxes and profit method (CAP)
This Brazilian equivalent of the CP method is defined as the weighted average cost of an acquisition or production of exported property, services, or rights increased for taxes and duties imposed by Brazil, plus a profit margin of 15%, calculated based on the sum of the costs, taxes and duties.

Quotation price on exports' method (PECEX)
This new Brazilian method, introduced by Law 12715/12, must be applied to test exports of commodities that have a quote in a commodities' exchange, as of 2013. Based on this method, taxpayers shall compare the transaction value with the average quote of the respective commodity involved, adjusted by an average market premium, in the date of the transaction. In the case of transactions involving commodities that do not have a quote in a commodities' exchange, taxpayers may choose to test the prices in export transactions based on information obtained from independent sources, provided by internationally recognised institutes involved in researches of specific sectors as well as by Brazilian regulatory agencies. Taxpayers must apply this method to test commodities quoted in the exchange market, even if their average export sales' price are at least 90% of the average domestic sales' price of the same goods.

In the event that the export sales' price of a specific inter-company transaction is equal to, or more than, the transfer price determined by one of these methods, no adjustment is required. On the other hand, if the export sales' price of a specific inter-company export transaction is less than the determined transfer price, the taxpayer is required to make an adjustment to the calculation bases of income tax and social contribution.

Relief of proof rule for inter-company export transactions
In addition to the statutory 90% safe harbour rule for inter-company export transactions, there is a secondary compliance rule (herein referred to as the 'relief of proof rule') whereby a taxpayer may be relieved of the obligation to substantiate the export sales' price to foreign-related persons using one of the statutory methods if it can demonstrate either of the following:

Net income derived from inter-company export sales, taking into account the average for the calculation period and the two preceding years, excluding companies in low-tax jurisdictions and transactions for which the taxpayer is permitted to use different fixed margins, is at least 10% of the revenue from such sales, provided the exports to related parties do not exceed 20% of the total exports.

Net revenues from exports do not exceed 5% of the taxpayer's total net revenues in the corresponding fiscal year.

If a taxpayer can satisfy the relief of proof rule, the taxpayer may prove that the export sales' prices charged to related foreign persons are adequate for Brazilian tax purposes using only the export documents related to those transactions.

The relief of proof rules do not apply to export transactions carried out with companies located in low-tax jurisdictions or beneficiaries of a privileged tax regime, and they do not apply to exports subject to the mandatory adoption of the PCEX method.

Exchange adjustment
In an attempt to minimise the effect of the appreciation of local currency *vis-à-vis* the US dollar and the euro, the Brazilian authorities issued ordinances and normative instructions at the end of 2005, 2006, 2007, 2008, 2010 and 2011, which amended the Brazilian TP legislation for export transactions only. Per these amendments, Brazilian exporting companies were allowed to increase their export revenues for calendar years 2005, 2006, 2007, 2008, 2010 and 2011 (for TP calculation purposes only), using the ratio of 1.35, 1.29, 1.28, 1.20, 1.09 and 1.11, respectively. For 2009, 2012 and 2013, no exchange adjustment was allowed. This exceptional measure only applied for those years, and for the statutory 90% safe harbour, the net income relief of proof and CAP method.

Divergence margin
For inter-company import and export transactions, even if the actually practised transfer price is above the determined transfer price (for import transactions) or below the determined transfer price (for export transactions), no adjustment will be required as long as the actual import transfer price does not exceed the determined transfer price by more than 5% (i.e. as long as the actual export transfer price is not below the calculated transfer price by more than 5%).

The divergence margin accepted between the parameter price obtained through the use of PCI and PECEX methods and the tested price is 3%.

Rules regarding interest on debt paid to a foreign-related person
Rules applicable until 31 December 2012
The statutory rules provide that interest on related-party loans that were duly registered with the Brazilian Central Bank before 31 December 2012 is not to be subject to TP adjustments. However, interest paid on a loan issued to a related person that was

not registered with the Brazilian Central Bank will be deductible, only to the extent that the interest rate does not exceed the LIBOR (London interbank offered rate) dollar rate for six-month loans plus 3% per year (adjusted to the contract period). The actual amount of the interest paid on the loan in excess of this limitation will not be deductible for income tax and social contribution purposes.

The rules do not provide a reallocation rule, which would treat the foreign lender as having received less interest income for withholding tax (WHT) purposes. Because the foreign lender actually received the full amount of the interest in cash, the foreign lender will still be required to pay WHT at the rate of 15% on the full amount paid including the excess interest.

Similarly, loans extended by a Brazilian company to a foreign-related party, which were not registered with the Brazilian Central Bank must charge interest at least equal to the LIBOR dollar rate for six-month loans plus 3%.

In the case of renewal or renegotiation of the loan terms after 1 January 2013, the respective interest will be subject to the TP rules applicable as of this date, as described below.

Rules applicable as of 1 January 2013

As of 1 January 2013, interest on related-party loans, even if resulting from agreements duly registered with the Brazilian Central Bank, will be deductible only up to the amount that does not exceed the rate determined based on the following rules, plus a spread determined by the Ministry of Finance:

- In case of transaction in US dollars subject to fixed interest rate: rate of Brazilian sovereign bonds issued in US dollars in foreign markets.
- In case of transaction in Brazilian reais subject to fixed interest rate: rate of Brazilian sovereign bonds issued in Brazilian reais in foreign markets.
- In all other cases: London interbank offered rate – LIBOR for the period of six months.

In the case of transactions in Brazilian reais, subject to floating interest rate, the Ministry of Finance can determine a different base rate.

For transactions covered in item III above in currencies for which there is no specific LIBOR rate disclosed, the LIBOR for US dollar deposits must be considered.

The Brazilian Ministry of Finance established that the interest deduction will be limited to the interest determined considering a spread of 3.5% on top of the maximum interest rate applicable to the case, according to the Law. Interest expenses in excess to such limit will not be deductible. On the other hand, the minimum interest income to be recognised for tax purposes as of 3 August2013 on loans granted abroad is determined considering the spread of 2.5% on top of the minimum interest rate applicable to the case according to the Law.

The deductibility limit must be verified on the contract date, and it will apply during the full contract term. For this purpose, the renewal and the renegotiation of contracts will be treated as the signing of a new contract.

Rules regarding royalties and technical assistance
The statutory rules expressly exclude royalties and technical, scientific, administrative or similar assistance remittances from the scope of the TP legislation. Accordingly, provisions of the Brazilian income-tax law established before the Brazilian TP rules went into effect still regulate the remittances and deductibility of inter-company payments for royalties and technical assistance fees.

According to this preceding legislation, royalties for the use of patents, trademarks and know-how, as well as remuneration for technical, scientific, administrative or other assistance paid by a Brazilian entity to a foreign-related party are only deductible up to a fixed percentage limit set by the Brazilian Ministry of Finance. The percentage limit depends on the type of underlying royalty, product or industry involved (the maximum is 5% of related revenues, 1% in the case of trademarks).

Additionally, royalties and technical assistance fees are only deductible if the underlying contracts signed between the related parties have been approved by the National Institute of Industrial Property (INPI) and registered with the Brazilian Central Bank after 31 December 1991. Royalty payments that do not comply with these regulations and restrictions are not deductible for income tax.

Consequently, while royalty and technical assistance payments are not subject to TP rules, they are subject to rules that impose fixed parameters that are not in accordance with the arm's-length principle, except for royalties for the use of a copyright (e.g. software licences), which are not subject to the rate limitations mentioned above and, in most cases, are paid at much higher rates. Such remittances are subject to Brazil's TP rules for import transactions.

The Brazilian TP regulations make no mention of royalty and technical assistance payments received by a Brazilian taxpayer from a foreign-related party. Hence, such foreign-source revenues should be subject to Brazil's TP rules for export transactions.

Cost-contribution arrangements
No statutory or other regulations on cost-contribution arrangements have been enacted at this point. Accordingly, deductibility of expenses deriving from cost-contribution arrangements is subject to Brazil's general rules on deductibility, which require deductible expenses to be (1) actually incurred, (2) ordinary and necessary for the transactions or business activities of the Brazilian entity, and (3) properly documented.

Based on our experience, Brazilian tax authorities will assume that related charges merely represent an allocation of costs made by the foreign company. Consequently, they will disallow deductibility for income tax and social contribution on net income unless the Brazilian taxpayer can prove that it actually received an identifiable benefit from each of the charged services specified in any corresponding contracts. Sufficient support documentation is crucial to substantiate any claims that expenses are ordinary and necessary, especially in the case of international inter-company cost-contribution arrangements.

In past decisions, the Brazilian tax authorities and local courts have repeatedly ruled against the deductibility of expenses deriving from cost-contribution arrangements, due to the lack of proof that services and related benefits had actually been received by the Brazilian entity. In addition, in past decisions Brazilian tax authorities have

ruled against the deductibility of R&D expenses incurred by a foreign-related party and allocated as part of the production cost base in the calculation of the CPL for inter-company import transactions.

With the exception of cost-contribution arrangements involving technical and scientific assistance with a transfer of technology, which are treated the same as royalties (please see above), resulting inter-company charges will have to comply with Brazil's TP regulations, in order to be fully deductible. Due to the nature of the transaction, the CPL is the most commonly adopted method.

Back-to-back transactions

Back-to-back transactions are subject to TP rules. For this purpose, back-to-back transactions should be considered as those in which the product is purchased from a foreign party and sold to another foreign party – and at least one of them is treated as a related party for Brazilian TP purposes – without the transit of goods in Brazil.

Penalties

Assessments and penalties

In making an assessment if taxpayers are not able to present a new calculation and its support documentation in 30 days after the first one has been disqualified, the tax inspector is not required to use the most favourable method available. Consequently, the inspector will most likely use the method that is most easily applied under the circumstances and assess income tax and social contribution at the maximum combined rate of 34%. The objective of an assessment would not necessarily result in the true arm's-length result, but would be based on an objective price determined by the regulations.

In the case of exports, tax inspectors would most likely use the CAP, because they could rely on the Brazilian cost accounting information of the taxpayer. In the case of imports, the tax inspector may have independent data collected from customs' authorities, using import prices set by other importers for comparable products, based on the customs' valuation rules, or use the PRL.

If the Brazilian tax authorities were to conclude that there is a deficiency and make an income adjustment, penalties may be imposed at the rate of 75% of the assessed tax deficiency. The rate may be reduced by 50% of the penalty imposed if the taxpayer agrees to pay the assessed tax deficiency within 30 days without contesting the assessment. In some cases, when the taxpayer fails to provide the required information the penalty rate may be increased to 112.5% of the tax liability. In addition, interest would be imposed on the amount of the tax deficiency from the date the tax would have been due if it had been properly recognised. In this instance, the interest rate used is the federal rate established by the Brazilian Central Bank, known as SELIC.

Resources available to the tax authorities

The Brazilian tax authorities have created a group of agents specialised in TP audits. In addition, all tax agencies have a special area dedicated to the investigation and development of audits that conduct studies and form databases that can be used to compare prices and profit margins across industries and to identify questionable companies for audit. The electronic contemporaneous documentation filing requirements (DIPJ, recently replaced by ECF – Tax Accounting Recording) for TP purposes facilitate the creation of such comprehensive databases. Since taxpayers are

required to report in the DIPJ or ECF the average annual transfer prices for the 199 largest inter-company import and export transactions, the Brazilian tax authorities will be able to test these prices using the prices of similar products traded by other companies. In addition, as mentioned earlier, the tax inspector may also use data collected from the customs authorities' electronic Integrated System for International Trade (*Sistema Integrado de Comércio Exterior*, or SISCOMEX), as well as from the Integrated System of Foreign Service Trade (*Sistema Integrado de Comércio Exterior de Serviços, Intangíveis e outras operações que produzam variações no patrimônio*, or SISCOSERV).

Liaison with customs' authorities
In principle, it should not be possible to have different import values for customs and TP purposes. However, in determining import sales' prices, the TP rules and customs' valuation rules are not the same. It is quite common to find that the customs and TP rules result in different import prices. In practice, many multinational companies find themselves having to use an import sales price for customs' purposes, which is higher than the price determined by the TP rules. As a result, these companies pay higher customs' duties and, at the same time, make a downward adjustment to the price for TP purposes.

Limitation of double taxation and competent authority proceedings
Should the Brazilian tax authorities adjust transfer prices, it is possible that the same income could be taxed twice, once in Brazil and once in the foreign country. Multinational companies conducting transactions with their Brazilian affiliates through countries that do not have double-tax agreements (DTAs) with Brazil, such as the US and the UK, cannot pursue competent authority relief as a means of preventing double taxation arising from an income adjustment. Conversely, multinational companies conducting transactions with their Brazilian affiliates through countries that have DTAs with Brazil may appeal for relief under the competent authority provisions of Brazil's tax treaties. However, few taxpayers have tested this recourse, and none successfully. This is because Brazilian TP rules were enacted after the various tax treaties had been signed, so the reasons for evoking competent authority relief on TP grounds did not yet exist.

Documentation
Contemporaneous documentation requirements
Many taxpayers initially failed to appreciate the complexities created by the Brazilian TP rules and their practical application to particular circumstances.

The general impression held by many companies was that the fixed-income margins established by the Brazilian rules made it easier to comply with the rules and eliminated the need for detailed economic studies and supporting documentation. In practice, however, the application of the rules has shown that they are more complicated than they might appear. The amount of information necessary to comply with the rules was underestimated because the regulations did not provide any contemporaneous documentation requirements.

This changed in August 1999, when the Brazilian tax authorities issued information requirements concerning TP as part of the manual for filing the annual income-tax return (*Declaração de Informações Econômico-Fiscais da Pessoa Jurídica*, or DIPJ, recently replaced by ECF). These documentation requirements, which include five

information forms (*Fichas*) in the tax return for disclosure of transactions conducted with foreign-related parties, greatly increased the TP compliance burden. These forms oblige taxpayers filing their annual tax returns to provide detailed disclosure regarding their inter-company import and export transactions, the method applied to test the inter- company price for the 199 largest import and export transactions, and the amount of any adjustments to income resulting from the application of the method to a specific transaction during the fiscal year in question.

For most companies, the elements needed to comply with the information requirements imposed by the information returns and a possible TP audit should be available through analytical information or the accounting system. However, many companies have yet to develop the systems that can provide the information needed to comply with these requirements as well as for purposes of determining the best TP methodology.

Transfer pricing controversy and dispute resolution

Burden of proof

The taxpayer is obliged to satisfy the burden of proof that it has complied with the TP regulations as of the date the annual corporate income-tax return is filed. However, the fact that the Brazilian rules allow taxpayers to choose from several methods for each type of transaction provides properly prepared taxpayers an advantage over the tax authorities. Proper and timely preparation enables taxpayers to collect the necessary information and choose the most appropriate method in advance.

The rules also state that the tax authorities can disregard information when considered unsuitable or inconsistent. Assuming the methodology is applied and documented correctly, taxpayers can satisfy the burden of proof and push the burden back to the tax authorities. This also applies when a taxpayer can satisfy the relief of proof rule for inter-company export transactions.

Tax audit procedures

Audits are the Brazilian tax authorities' main enforcement tool with regard to TP. Transfer pricing may be reviewed as part of a comprehensive tax audit or through a specific TP audit.

The audit procedure

The audit procedure occurs annually, except in some cases such as suspicion of fraud.

As part of the audit process, the regulations require a Brazilian taxpayer to provide the TP calculation used to test inter-company transactions conducted with foreign-related parties, along with supporting documentation. Since the taxpayer is obliged to satisfy the burden of proof that it has complied with the TP regulations as of the date the tax return is filed, it is important for taxpayers to have their support and calculations prepared at that time. If the taxpayer fails to provide complete information regarding the methodologies and the supporting documentation, the regulations grant the tax inspector the authority to make a TP adjustment based on available financial information by applying one of the applicable methods. As from calendar year 2012, taxpayers can only change the method adopted before the start of the audit procedure, unless the tax authorities disqualify the existing documentation; in this case, taxpayers will have 30 days to present a new calculation based on another method and the corresponding support documentation.

As part of the audit process, the tax inspectors typically request that the methods used by the taxpayer be reconciled with the accounting books and records. The tax inspector also requests any significant accounting information used to independently confirm the calculations performed by the company. The information requested by the tax inspector may be quite burdensome and may require the company to provide confidential data regarding the production cost per product, the prices charged in the domestic market, and the prices charged to foreign-related and independent parties.

As previously mentioned, companies need to develop the necessary information-reporting systems and controls that can provide reliable accounting information regarding all transactions conducted with foreign-related parties in advance to properly defend on audit.

Legal cases

A significant issue under dispute between taxpayers and the tax authorities relates to the mechanics for calculating the PRL 60%. Normative Instruction (IN) 243 issued in 2002, introduced significant changes to the calculation of the PRL method, creating a controversy regarding whether it expanded the scope beyond what the law intended. As a result of this controversy, most companies ignored the IN 243 provisions related to the PRL 60% calculation, which would yield much higher taxable income than the mechanics of the previous regulations. The Brazilian tax authorities have begun issuing large tax assessments based on IN 243.

The Taxpayers' Council decided in several cases against the taxpayers, and recently there were a few decisions in favour of taxpayers. Also, a Federal Regional Court (that it is not yet a final instance of this legal dispute) decided against a taxpayer, in an overturn of the same Court's position from a few months back. In any event, the final decision on this dispute will only be known when it reaches the Superior Courts. As of 2013 the mechanics for calculating PRL 60% according to IN 243 provisions was included in Law 12715, but with profit margins of 20%, 30% or 40%, according to each industry/sector (*see comments above*). This change in the tax law will end the dispute regarding this matter as of calendar year 2013.

Comparison with OECD Guidelines

The rules require that a Brazilian company substantiate its inter-company import and export prices on an annual basis by comparing the actual transfer price with a parameter price determined under any one of the Brazilian equivalents of the OECD's comparable uncontrolled price method (CUP method), resale price method (RPM) or cost plus method (CP method). Taxpayers are required to apply the same method, which they elect, for each product or type of transaction consistently throughout the respective fiscal year. However, taxpayers are not required to apply the same method for different products and services.

While incorporating these transaction-based methods, the drafters of the Brazilian TP rules excluded profit-based methods, such as the TNMM or PSM. This is contrary to the OECD Guidelines and the US TP regulations, as well as the TP regulations introduced in Mexico and Argentina.

Other material differences from internationally adopted TP regimes include the Brazilian TP legislation's exclusion of a best method or most appropriate method rule; accordingly, a taxpayer may choose the respective pricing method. In addition,

the Brazilian TP rules explicitly exclude inter-company royalties and technical, scientific, administrative or similar assistance fees, which remain subject to previously established deductibility limits and other specific regulations.

OECD issues
As with many other countries, Brazil is still in the early stages of developing its TP policies. Brazil's TP regime has been criticised abroad for its failure to abide by international TP principles. The Brazilian TP rules focus not on the identification of the true arm's-length price or profit but on objective methods for determining what the 'appropriate' transfer price should be for Brazilian tax purposes. The regulations themselves do not mention the arm's-length principle, and the rules do not expressly require that related parties conduct their operations in the same manner as independent parties.

Brazil is not an OECD member country. However, in the preamble to the tax bill that introduced the TP rules, the Brazilian government stated that the new rules conformed to the rules adopted by OECD member countries. In a ruling, the Brazilian tax authorities reaffirmed their opinion that Brazil's TP regulations are in line with the arm's-length principle as established in Article 9 of the OECD Model Tax Convention. Although these pronouncements appear to be an endorsement of the arm's-length principle as the norm for evaluating the results achieved by multinational enterprises in their international inter-company transactions, the regulations do not provide the same level of explicit guidance and flexibility provided by the OECD Guidelines.

The fixed percentage margin rules, which have the appearance of safe harbours, are designed to facilitate administration and compliance, and not necessarily to foster a fair and flexible system seeking maximum compatibility with the arm's-length principle. The Brazilian rules prescribe methodologies for computing arm's-length prices that are different from the methodologies approved by the US regulations and the OECD Guidelines, and apply to transactions between certain unrelated parties. In other areas, such as technology transfers and cost-contribution arrangements, Brazil has failed altogether to establish TP rules.

The question is whether non-Brazilian OECD-compliant methods may be applied by taxpayers in valid situations when the three Brazilian transaction-based methods cannot be applied for practical reasons (for example, lack of applicability in general or lack of reliable information). In the case of transactions conducted with related parties in treaty countries, there is a strong basis supporting the conclusion that the treaties, which are based on the OECD model treaty and supersede Brazilian domestic laws, should allow a Brazilian company to apply profit-based methods accepted by the OECD.

In practice, however, the Brazilian tax authorities have demonstrated that they clearly do not agree with this interpretation, especially when it comes to methodologies not provided in the Brazilian TP regulations. In TP audits, the Brazilian tax authorities have repeatedly rejected economic studies prepared in line with the arm's-length principle under observance of the OECD Guidelines as acceptable documentation. It can be assumed that the Brazilian tax authorities do not want to set a precedent that would allow multinational companies to bypass the rigid Brazilian documentation methods in favour of more flexible OECD approaches. Defending the use of OECD methodologies may eventually be resolved in the courts, although such a resolution would involve a lengthy and costly legal process.

Definition of related persons
Brazil's TP rules provide a much broader definition of related parties than do internationally accepted TP principles. As described in the following section, the regulations go so far as to characterise foreign persons as being related when they are located in low-tax jurisdictions, whether or not a relationship exists between them and the Brazilian entity. The statutory list of related persons illustrates that the TP regulations clearly target foreign-related parties since none of the listed relationships would result in a Brazilian company being considered as related to another Brazilian company. Consequently, the TP rules do not apply to two Brazilian sister companies. Inter-company transactions in a purely domestic context are covered by the disguised dividend distribution rules described below, which are less rigorous.

Under the statutory rules, a foreign company and a Brazilian company may be considered to be related if the foreign company owns as little as 10% of the Brazilian company, or when the same person owns at least 10% of the capital of each.

Additionally, regardless of any underlying relationship, the Brazilian definition of related parties considers a foreign person to be related to a Brazilian company if, in the case of export transactions, the foreign person operates as an exclusive agent of the Brazilian company or, in the case of import transactions, the Brazilian company operates as an exclusive agent of the foreign person. This broad definition was specifically designed to control potential price manipulations between third parties in an exclusive commercial relationship. For these purposes, exclusivity is evidenced by a formal written contract, or in the absence of one, by the practice of commercial operations relating to a specific product, service or right that are carried out exclusively between the two companies or exclusively via the intermediation of one of them. An exclusive distributor or dealer is considered to be the individual or legal entity with exclusive rights in one region or throughout the entire country.

Companies located in low-tax jurisdictions or beneficiaries of privileged tax regime
Under the regulations, the TP rules apply to transactions conducted with a foreign resident, even if unrelated, that is domiciled in a country that does not tax income or that taxes income at a rate of less than 20%, or in a jurisdiction with internal legislation allowing secrecy in regard to corporate ownership. For these purposes, the tax legislation of the referred country applicable to individuals or legal entities will be considered, depending on the nature of the party with which the operation was carried out. The TP provisions also apply to transactions performed in a privileged tax regime, between individuals or legal entities resident or domiciled in Brazil and any individuals or legal entities, even if not related, resident or domiciled abroad. These rules create some practical compliance issues because they require Brazilian companies to apply the Brazilian TP rules with respect to transactions conducted with companies in tax havens even though the parties are completely unrelated.

In an effort to facilitate compliance by taxpayers, the Brazilian tax authorities have issued a list of jurisdictions that they consider to be tax havens or without disclosure of corporate ownership. This list currently includes the following jurisdictions: American Samoa, Andorra, Anguilla, Antigua and Barbuda, Dutch Antilles, Aruba, Ascension Island, Bahamas, Bahrain, Barbados, Belize, Bermuda, Brunei, Campione D'Italia, Singapore, Cyprus, Costa Rica, Djibouti, Dominica, French Polynesia, Gibraltar, Granada, Cayman Islands, Cook Islands, Island of Madeira (Portugal), Isle of Man, Pitcairn Islands, Qeshm Island, Channel Islands (Jersey, Guernsey, Alderney,

Sark), Hong Kong, Kiribati, Marshall Islands, Samoa Islands, Solomon Islands, Saint Helena Island, Turks and Caicos Islands, British Virgin Islands, US Virgin Islands, Labuan, Lebanon, Liberia, Liechtenstein, Macau, Maldives, Mauritius, Monaco, Montserrat, Nauru, Niue Island, Norfolk Island, Oman, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Pierre and Miquelon, Saint Vincent and Grenadines, San Marino, Seychelles, Swaziland, Tonga, Tristan da Cunha, Vanuatu and United Arab Emirates. The list of privileged tax regimes includes: *Sociedad Anonima Financiera de Inversion* (SAFI) incorporated under Uruguayan law until December 2010, holding companies incorporated under Danish law and under Dutch law which do not have substantial economic activity, international trading companies (ITC) incorporated under Icelandic law, limited liability companies (LLCs) incorporated under US state law (in which the equity interest is held by non-residents and which are not subject to US federal income tax), ITCs and international holding companies (IHC) incorporated under Maltese law, and Swiss holding companies, domiciliary companies, auxiliary companies, mixed companies or administrative companies which combined income tax rate is less than 20%.

Currently, the inclusion of Dutch holding companies and Spanish companies incorporated as '*Entidades de Valores Extranjeros*' or 'ETVEs' is suspended as a result of a request made to the Brazilian government by those countries, until their inclusion is further evaluated by the Brazilian authorities.

Advance pricing agreements (APAs)

While Brazil's TP rules do not expressly refer to the institution of APAs, the statutory rules offer some leeway for the negotiation of an advance ruling from the tax authorities, stating that a taxpayer's transfer prices are appropriate, even though they do not meet the fixed profit margins contained in the statute. The regulations specifically state that taxpayers may file ruling requests to alter the fixed profit margins for either industry sectors or individual taxpayers. Careful planning and substantial documentation will be necessary to justify lower margins to the Brazilian tax authorities.

To date, however, the few companies that filed ruling requests with the Brazilian tax authorities have not succeeded in obtaining different margins.

Disguised dividend distributions

Brazil's income tax law lists seven types of related-party transactions (domestic and international) that are deemed to give rise to disguised distributions of dividends. In summary, such disguised distributions of dividends encompass all transactions between a Brazilian legal entity and its individual or corporate administrator(s) and/or controlling partner(s) or shareholder(s), which are negotiated at terms more favourable than fair market value. In the concrete case of related-party financing transactions, these rules have a certain analogy to thin capitalisation rules or practices. Amounts characterised as disguised dividends are added to the taxable income of the legal entity deemed to have performed such a disguised distribution. This rule does not apply when the taxpayer can substantiate that the terms of the related-party transactions were at fair market value. However, as previously mentioned, compliance with these disguised dividend distribution rules is less rigorously enforced than compliance with the TP rules, which focus exclusively on international inter-company transactions.

Brazil

19.

Bulgaria

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Overview

Transfer pricing (TP) rules were issued by the Minister of Finance on 29 August 2006. Bulgarian TP rules generally follow the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.

Country	Bulgaria
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes, generally
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	N/A
When must TP documentation be prepared?	No explicit TP documentation requirements, but is required upon request during audit
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	N/A
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	Penalties are calculated as a percentage of any TP adjustment

Bulgaria

Introduction

The Bulgarian tax legislation requires that taxpayers determine their taxable profits and income by applying the arm's-length principle to the prices for which they exchange goods, services and intangibles with related parties (i.e. transfer prices). Interest on loans provided by related parties should be consistent with market conditions at the time the loan agreement is concluded.

The TP rules apply for transactions between resident persons, as well as for transactions between resident persons and non-residents.

Legislation and guidance

Statutory rules

Bulgarian TP rules are provided in the Corporate Income Tax Act (CITA), the Tax and Social Security Procedures code, as well as in Ordinance № H-9 for implementation of the TP methods, issued by the Minister of Finance on 29 August 2006.

The CITA sets the arm's-length principle and explicitly determines cases where the prices are deemed not to comply with the principle (e.g. in cases of receiving or granting loans that carry an interest rate that differs from the market interest rate effective at the time the loan agreement is concluded).

The Tax and Social Security Procedures code includes a definition of related parties and stipulates the method to be used when determining prices on transactions between related parties.

Definition of related parties

For tax purposes, related parties are:

- Spouses, relatives of the direct descent without restrictions and relatives of the collateral descent up to the third degree included, and in-law lineage, up to and including the second degree.
- Employer and employee.
- Persons, one of whom participates in the management of the other or of its subsidiary.
- Partners.
- Persons in whose management or supervisory bodies one and the same legal or natural person participates, including when the natural person represents another person.
- A company and a person who own more than 5% of the voting shares of the company.
- Persons whose activity is controlled, directly or indirectly, by a third party or by its subsidiary.
- Persons who control together, directly or indirectly, a third party or its subsidiary.
- Persons, one of whom is an agent of the other.
- Persons, one of whom has made a donation to the other.
- Persons who participate, directly or indirectly, in the management, control or capital of another person or persons where conditions different from the usual may be negotiated between them.
- Persons, one of whom controls the other.

In addition, according to specific provisions in the Tax and Social Security Procedures Code, if a party to a transaction is a non-resident person, the revenue authorities may deem that the parties are related if:

- the non-resident entity is incorporated in a country, which is not a European Union (EU) Member and in which the profit or the corporate tax due on the income, which the non-resident has realised or would realise from the transactions, is below 40% of the tax due in Bulgaria, except if there is evidence that the non-resident person is subject to preferential tax treatment, or that the non-resident has sold the goods or services on the domestic market, and
- the country in which the non-resident is incorporated, denies or is not able to provide information regarding the effected transactions or the relations, when there is an applicable double-tax treaty (DTT) with this country.

Methods for determining market prices
For the purposes of TP rules, market prices are determined by:

- the comparable uncontrolled price (CUP) method
- the resale price method (RPM)
- the cost plus (CP) method
- the transactional net margin method (TNMM), and
- the profit split method (PSM).

Ordinance № H-9 for implementation of the TP methods stipulates the methods to be used when determining prices on related-party transactions, the application of each method, as well as the approach of the tax authorities in case the taxpayer has TP documentation in place.

Other regulations
The Bulgarian National Revenue Agency published internal TP guidelines on 8 February 2010. Generally, the guidelines contain information on recommended documentation that the revenue authorities should request during tax procedures, the TP methods, as well as some procedural rules for the avoidance of double taxation. The guidelines will be used by the revenue authorities when auditing related-party transactions and are not obligatory for taxpayers.

Thin capitalisation
According to the Bulgarian thin capitalisation rules, the interest expenses incurred by a resident company may not be fully deductible if the average debt-to-equity (D/E) ratio of the company exceeds 3:1 in the respective year. However, even if the D/E test is not met, the thin capitalisation restrictions may not apply if the company has sufficient profits before interest to cover its interest expenses.

Interest under bank loans or financial leases are not restricted by the thin capitalisation rules unless the transaction is between related parties or the respective loan or lease is guaranteed by a related party.

The Bulgarian thin capitalisation rules also do not apply to interest disallowed on other grounds (e.g. for TP purposes) and interest and other loan-related expenses capitalised in the value of an asset in accordance with the applicable accounting standards.

Even if some interest expenses are disallowed under thin capitalisation rules, they may be reversed during the following five consecutive years if there are sufficient profits.

Management services
The Bulgarian TP rules do not contain specific tax regulations regarding management services.

Resources available to the tax authorities
Bulgarian revenue authorities do not have special teams dealing with TP issues. The relevant investigations are performed as a part of the general tax audit procedures.

Use and availability of comparable information
The taxpayers may use all relevant sources of comparable information in order to support the arm's-length compliance of the transfer prices with the relevant market conditions.

If the tax authorities challenge the transfer prices, they may use various sources such as statistical information, stock market data and other specialised price information. The tax authorities should duly quote the source of its information.

In Bulgaria there are no databases containing information on unrelated-party transactions.

The financial statements of the local companies are publicly available, but are not collected in a single database that can be used for TP studies.

Risk transactions or industries
No transactions or industries can be considered exposed to TP investigations at a higher risk.

Penalties

Additional tax and penalties
Apart from an adverse tax assessment in respect of additional tax liabilities, the taxpayer may be subject to certain penalties.

If the taxpayer does not determine their tax obligations correctly and files a tax return declaring lower tax liabilities than as per strictly applying the TP provisions, a penalty between 250 euros (EUR) and EUR 1,500 may be imposed.

The difference between the agreed transfer prices and the market price may be considered as a hidden profit distribution, which will be associated with a penalty equal to 20% of the respective difference.

If the taxpayer does not provide evidence that the prices agreed with the related parties are market-based, a penalty between EUR 125 and EUR 250 may be levied.

Documentation

Documentation requirements
According to Bulgarian legislation, the taxable person is obliged to hold evidence that its relations with related parties are in line with the arm's-length principle. The tax provisions do not contain specific requirements regarding the filing of transfer pricing documentation (TPD) with revenue authorities.

The internal TP guidelines of the National Revenue Agency, however, contain indications as to the types of documents that the revenue authorities may request from taxpayers during tax procedures (e.g. during tax audits, procedures for DTT application, etc.). Although the guidelines do not introduce obligatory TPD requirements for taxpayers, they do specify the approach the revenue authorities should follow when examining intragroup transactions.

According to Ordinance № H-9 for implementation of the TP methods, if companies have available TPD, the revenue authorities are obliged to start their analyses of the intragroup prices, based on the method chosen by the taxpayer.

Transfer pricing controversy and dispute resolution

Legal cases

To date, there have been few court cases related to TP issues, and all of them occurred prior to the implementation of Ordinance № H-9. Most of them set the general principle for determination of the prices on related-party transactions by referring to the TP methods stipulated in the tax legislation.

Burden of proof

Taxpayers should be able to prove that the transfer prices are market-based. If the taxpayer does not provide evidence that the transfer prices are market-based, the revenue authorities may estimate the market prices. In such a case, the burden of proof shifts to the revenue/tax authorities and they should back up their findings with sufficient evidence.

Tax audit procedures

Transfer pricing may be examined during a regular tax audit, as there are no separate procedures for TP investigations.

During a tax audit, the revenue authorities may request additional information in order to make an assessment related to TP. The term for provision of information by the taxpayer will be determined in the tax authority's request (however, the term cannot be less than seven days).

Revised assessments and the appeals' procedure

If the transfer prices are not market-based, the revenue authorities may adjust the taxable result of the entity, and assess additional tax liabilities. Any tax assessments can be appealed at an administrative level. If the appeal fails, the assessments may be challenged in the court.

The statute of limitations (i.e. the period within which state authorities are entitled to collect the tax liabilities and other related mandatory payments) is five years from the end of the year in which the tax liabilities become payable. However, this period could be extended in certain cases (e.g. a tax audit). However, the maximum period of the statute of limitation is ten years.

Limitation of double taxation and competent authority proceedings

The DTTs concluded by Bulgaria provide taxpayers the opportunity to initiate a mutual agreement procedure (MAP) for the purposes of eliminating double taxation.

Regulations with respect to the MAP and the exchange of information with EU Member States have been introduced in the Bulgarian Tax and Social Security Procedures Code as of 1 January 2007.

The EU Arbitration Convention is applicable to Bulgaria per the European Parliament resolution of 17 June 2008.

There is no publicly available information on the competent authority proceedings undergone in Bulgaria.

Advance pricing agreements (APAs)
There is no possibility of obtaining APAs, pursuant to the local legislation. However, it is possible to obtain a written opinion from the revenue authorities on a case-by-case basis. Such opinions are not binding, but they may provide protection from assessment of interest for late payment and penalties.

Anticipated developments in law and practice
Although certain TP rules have been present in the Bulgarian tax legislation for a long time, there are no developed TP practices. However, in view of the recent amendments to the legislation, we expect revenue authorities will begin to pay greater attention to this area.

Liaison with customs' authorities
Pursuant to the customs' legislation, the base on which the customs' duties are calculated may be amended when the parties in the transaction are related. There are rules for determining the arm's-length price for customs' duties purposes using available data on comparable transactions.

Joint investigations
We are currently unaware of any simultaneous TP audits performed by the Bulgarian tax authorities and those of other countries.

Comparison with OECD Guidelines
Bulgaria is not a member of the OECD. However, the general principles of the OECD Guidelines are implemented in the Bulgarian TP rules and followed by the Bulgarian tax authorities.

20.

Cameroon, Republic of

PwC contact

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Overview

In Cameroon, transfer pricing (TP) is the new area of focus for the Tax Administration. The TP legislation and guidance complies with the Organisation for Economic Co-operation and Development (OECD) Guidelines 2010.

We believe that for in the coming fiscal year, the Tax Administration will strengthen the legislation and the audits on TP.

Country	**Cameroon**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Before the filing of the annual tax return with the tax administration, no later than 15th March for companies of the Large Taxpayers Unit (LTU).
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of any tax payment.

Cameroon, Republic of

Introduction

In order to fight against illicit transfers of profits, the Cameroonian General Tax Code (GTC) has provided rules implementing TP provisions in its section 19. These rules follow the TP regime developed by the OECD. According to said rules, the companies and multinational groups should determine the price of their internal transactions according to the arm's-length principle. It is up to the tax administration to examine the overall relationship between the related entities to determine whether their results are consistent with this principle.

The circular N°0004/MINFI/DGI/LC/L applying the provisions of the finance law for fiscal year 2007 completes section 19 of the General Tax Code by establishing the terms and conditions for implementation of the request by the tax authorities for information relating to the determination of TP. For this purpose, the circular states that the request for information on TP should occur only in the context of general or partial tax audit. Also, the tax administration should have gathered evidences suggesting that an enterprise has made a transfer of profits within the meaning of section 19 of the General Tax Code, demonstrating, firstly, that there are dependencies between the companies concerned, and secondly, whether the transaction was carried out under abnormal conditions.

In the same way, the Finance Law for 2012 reinforces the provision of article L 19 by establishing the obligation of automatic production of TP documentation by certain taxpayers of the Large Taxpayers Unit (LTU) during tax audits.

Likewise, the Finance Law for 2014 provides specific returns filing obligations for taxpayers of the LTU.

Finally, the tax administration accepts the procedure of advance pricing agreements (APA) in the application of OECD principles.

Legislation and guidance

The general context:

Section 19 of General Tax Code provides that:

"For the assessment of the company tax payable by companies which are controlled by, or which control an undertaking established outside Cameroon, the profits indirectly transferred to the latter by increasing or reducing the purchase or selling price, or by any other means, shall be incorporated in the results shown by their accounts.

The same shall apply to undertakings which are controlled by an under-taking or group likewise in control of undertakings established outside Cameroon".

The specific context:

The implementation of Cameroon legal provisions on TP is clarified by circular N°0004/MINFI/DGI/LC/L applying the provisions of the finance law for fiscal year 2007 and circular N°001/MINFI/DGI/LC/L of 30 January 2012 applying the provisions of finance law for the fiscal year 2012, as regards section L19bis of the Cameroon tax procedures code. However, the Cameroon regulations on TP do not specify which criteria should be taken into account in order to select and appropriate TP method.

The above-mentioned circular of 2007 regarding the justification by the company of the TP method used, merely states that any method invoked by the enterprise can be considered acceptable, provided that it is justified by the following documents:

- Contracts or internal memos describing the methods.
- Extracts of the general or analytical accounts.
- Economic analyses, notably on the markets, the functions fulfilled, the risks assumed, the comparable retained.

Therefore, what matters in practice is:

- the fact that a definite method has been applied consistently, and
- the results achieved through the retained method, and the way such results may be defended on the basis of comparables (internal, i.e. transactions between a group company and a third party, or external, i.e. transactions between companies not belonging to the group of the considered taxpayer).

To determine the price of normal operations, it is certainly possible to use methods based on profits. These include the division of profits, the transactional net margin method. However, it should focus on the following methods, which are based on arm's-length price and appear best suited to the Cameroonian environment:

- The comparable uncontrolled price (CUP) method.
- The resale price method (RPM).
- The cost plus (CP) method.

Section M 19a of the circular of Finance Law for 2012 establishes a new requirement which provides for the automatic production of certain TP documents by certain taxpayers during tax audits.

These taxpayers are henceforth required to submit to the tax administration, from the date of commencement of the tax audit carried on by tax administration, documentation that justifies the TP policy applied in transactions of any nature realised with legal entities established or incorporated outside Cameroon, and which are dependent or have control of businesses located in Cameroon.

The same applies to transactions with companies located in Cameroon and which are under the control of a company or group also having control over companies located outside Cameroon.

Companies liable to this automatic documentary obligation are those in the LTU, which meet one of the following conditions:

- At the close of the financial year, more than 25% of the capital or voting rights of a legal entity domiciled in Cameroon is owned directly or indirectly by an entity established or incorporated outside Cameroon.
- At the close of the financial year, more than 25% of the capital or voting rights of a legal entity domiciled outside Cameroon is owned directly or indirectly by an entity established or incorporated in Cameroon.

It should be noted that in case of partial or total failure of the taxpayer, a warning to provide or complete the documentation within thirty (30) days must be served to the taxpayer. This warning must recall the sanctions for failure to answer, notably adjustments based on information available to the Administration.

In this case, the onus of proof rests with the company.

The documents concerned are listed in appendix 3 of the circular of Finances Law for 2012.

Also, circular No 001/MINFI/DGI/LC/L, applying the provisions of the finance law for fiscal year 2014, provides that companies of the (LTU) are now required to automatically transmit the following information to the tax authorities no later than 15 March of each year.

- A statement of their shareholdings in other companies if the holdings exceed 25% of their share capital.
- A detailed statement of intergroup transactions.

1) With regards to the statement of their shareholdings in other companies if the holdings exceed 25% of their share capital
It should be noted that this requirement equally applies to affiliated or associated companies included in the scope of consolidation of the parent company as defined by the provisions of Article 78 of the OHADA Uniform Act on the Organisation and Harmonisation of Business Accounting.

The statement of shareholdings should be accompanied by the following items:

- A general description of activities deployed including all changes in securities which occurred over the past two years.
- A general description of the legal and operational structures of the associated group of companies including an identification of the associated companies with the group engaged in transactions with the company filing the tax return.
- A general description of the functions performed and risks assumed by the associates, in the manner in which they impact the company filing the tax return.
- A list of key intangible assets including patents, trademarks, business names and know-how related to the company filing the tax return.

2) With regards to the detailed statement of related party or intergroup transactions
The following information must be submitted before 15 of March yearly:

- A description of the transactions carried out with related companies including the nature and the amount of cash flow including royalties.
- A list of cost-sharing agreements and, if applicable, a copy of APAs and advance tax rulings relating to the determination of transfer prices, affecting the results of the company filing the tax return.
- A presentation of the TP determination method(s) with respect to the arm's-length principle including an analysis of the functions performed, assets used and risks assumed with an explanation on the selection and application of the method(s) used.
- When the chosen method requires an analysis of comparables considered relevant by the company.

Taxpayers who fail to meet the aforementioned filing requirements shall be summoned to do so within thirty (30) days. The summons would refer to the penalties due including potential tax adjustments in case of failure to reply.

Penalties

For TP, we apply the general penalties on income tax adjustments.

The penalties are calculated as a percentage of any tax payment. However, where the correction of errors in filing of returns or payment of taxes is carried out voluntarily by the taxpayer, no penalties shall be applied.

As from 1 January 2015, companies which have the obligation to submit their TP documentation no later than 15 March 2015, and which fail to file it within this set deadlines, shall pay the fine of 1 million *Communauté Financière Africaine* francs (XAF) per month after sending of a formal notice.

Documentation

Until 31 December 2011, section M19a of the GTC rendered it compulsory for companies to provide certain documents at the request of the administration, when in the course of an audit, elements showing an indirect transfer of profits, in accordance with Section 19 of the GTC, were discovered.

However, the amended version of this section induces new obligations (section M19a of the circular of Finances Law for 2012), different from those mentioned above, to companies that meet certain conditions (*for more details see the above paragraph on legislation and guidance*).

Following appendix 3 of the circular of Finances Law for 2012, the TP documentation must include:

- General information about the group of associated companies:
  - A general description of the legal and operational structures of the related entities including an identification of those related entities involved in the transactions being audited.
  - A general description of the functions performed and risks undertaken by related companies, where these affect the company being audited.
  - A list of key intangible assets held including patents, trademarks, trade names and technical knowledge, with regard to the company under audit.
  - A general description of the TP policy of the group.
- Specific information regarding the company under audit:
  - A description of the work done including changes in the audited financial year.
  - A description of transactions with other associates including the nature and amount of flow including royalties.
  - A list of cost-sharing arrangements and, where applicable, a copy of the prior agreements with respect to TP and relating to the determination of transfer prices affecting the results of the company audited.
  - Or a presentation of the methods for determining transfer prices in compliance with the arm's-length principle including an analysis of functions performed, assets used and risks assumed, and an explanation concerning the selection and application of the method(s) used.

- When required by the method chosen, an analysis of comparative elements considered relevant by the company.

Article 18-3 of Finances Law for 2014 requires that the taxpayers under LTU must submit their TP documentation for fiscal year 2013 no later than March 15, 2014.

Transfer pricing controversy and dispute resolution
When the tax authority makes an adjustment for the price of a transaction, the burden of proof rests with administration (*Art. L 23, General Tax Code*).

However, in case of partial or failure to submit the TP documentation, the burden of proof rests with the company (*Art. L 19bis, General Tax Code*).

During the tax audit, the administration focuses on the application of the TP method.

Some companies have already been the subject of control in such matters.

Therefore, in order to agree on the best method to adopt, the tax authorities accept the application of the Unilateral APA, which is adapted for Cameroonian environment for the moment.

Through this APA submission, Cameroon Entities requests that the Cameroonian Tax Administration (CTA) agrees on the appropriate TP methodology to establish arm's-length results for the covered transactions during a certain period.

Comparison with OECD Guidelines
In Cameroon, the TP legislation is applied in respect to application of the OECD principles (OECD Transfer Pricing Guidelines 2010).

21.

Canada

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Overview

There were significant changes to the global transfer pricing (TP) landscape in 2014, which in turn influenced the Canadian TP environment. The Organisaton for Economic Co-operation and Development's (OECD) mandate around base erosion and profit shifting (BEPS) continued to drive change and discussion of worldwide tax policies, as its first set of reports and recommendations to address seven of the actions in the Action Plan were released in September 2014. Canadian taxpayers are continuing to assess the impact of BEPS on their current structures and inter-company transactions, while at the same time dealing with aggressive audits by the Canada Revenue Agency (CRA) not just on TP issues but also on the procedural and timing aspects of audits. Overall, the changes in 2014 and expected future changes should make taxpayers actively assess risk and manage their TP positions.

Country	**Canada**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP Documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	On or before the tax return filing date for the tax year to provide penalty protection in the event of a transfer pricing adjustment.
Must TP documentation be prepared in the official/local language?	Yes

Canada

Country	Canada
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No, but TP documentation can be used to avoid TP penalties
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	10% of the net upward transfer pricing adjustments if the adjustment exceeds the penalty threshold, which is the lesser of Canadian dollars (CAD) 5 million or 10% of gross revenues.

Introduction

Canadian TP legislation and administrative guidelines are generally consistent with the OECD Guidelines and endorse the arm's-length principle, i.e., transactions between related parties must occur under arm's-length terms and conditions. Penalties may be imposed where adjustments exceed a threshold amount and contemporaneous documentation requirements are not met. To date there have only been a handful of major TP cases litigated in Canada, and the number of cases is expected to increase as the TP-related audit activity of the CRA continues to intensify under ongoing mandates from the federal government.

Legislation and guidance

Legislation and guidance related to transfer pricing

Canadian TP legislation is set out in section 247 of the Income Tax Act (ITA) and embodies the arm's-length principle:

- Related-party transactions may be adjusted if the CRA determines that they are not on arm's-length terms (subsection 247(2)). Note that a general anti-avoidance rule (GAAR) (section 245 of the ITA) can apply to any transaction considered to be an avoidance transaction, and may be applied in TP situations if subsection 247(2) does not apply.
- Transfer pricing adjustments that result in a net increase in income or a net decrease in a loss may be subject to a non-deductible 10% penalty (subsection 247(3)).
- Set-offs may reduce the amount of the adjustment subject to penalty where supporting documentation for the transaction that relates to the favourable adjustment is available (subsection 247(3)) and the adjustment is approved by the Minister of National Revenue (the Minister) (subsection 247(10)).
- Penalties may not apply to a transaction where reasonable efforts were made to determine and use arm's-length transfer prices. Contemporaneous documentation standards are legislated for that purpose (subsection 247(4)).
- 'Transfer price' is broadly defined to cover the consideration paid in all related-party transactions.

Transactions between related parties will be adjusted where the terms and conditions differ from those that would have been established between arm's-length parties. That is, the nature of the transaction can be adjusted (or recharacterised) in circumstances

where it is reasonable to consider that the primary purpose of the transaction is to obtain a tax benefit. A reduction, avoidance or deferral of tax (or increase in a refund of tax) will be viewed to be a 'tax benefit'.

The legislation does not include specific guidelines or safe harbours to measure arm's length; rather, it leaves scope for the application of judgment. The best protection against a tax authority adjustment and penalties is the maintenance of contemporaneous documentation. The nature of the documentation required to avoid penalties is described in the legislation.

The CRA also releases information explaining its interpretation of various taxation matters through the following publications:

- Information circulars (ICs), which deal with administrative and procedural matters.
- Transfer pricing memoranda (TPMs), which provide guidance on specific TP issues.
- Interpretation bulletins, which outline the CRA's interpretation of specific law.
- Advance tax rulings, which summarise certain advance tax rulings given by the CRA.

These publications describe departmental practice and do not have the authority of legislation. However, courts have found that these publications can be persuasive where there is doubt about the meaning of the legislation. News releases are another source of information that communicate changes in, and confirm the position of, the CRA on income tax issues. The TP ICs and TPMs issued by the CRA are set out below:

Information circulars (ICs)
- IC 87-2R, regarding guidance on the application of the TP rules as amended in 1998 to conform to the 1995 OECD Guidelines.
- IC 94-4R regarding advance pricing arrangements.
- IC 71-17R5 regarding competent authority assistance under Canada's tax conventions.
- IC 94-4RSR (Special Release) regarding advance pricing arrangements for small businesses.

Transfer pricing memoranda (TPMs)
- TPM-01 – Referrals to the Transfer Pricing Review Committee: This document has been replaced by TPM-07.
- TPM-02 – Repatriation of Funds by Non-Residents – Part XIII Assessments: This document explains the CRA's policy on the repatriation of funds following a TP adjustment under subsection 247(2) of the ITA (as this memo has not been updated since the date of issue, some information may no longer be valid).
- TPM-03 – Downward Transfer Pricing Adjustments under subsection 247(2): This document provides guidance on dealing with downward TP adjustments that may result from an audit or a taxpayer-requested adjustment.
- TPM 04 – Third-Party Information: This document provides guidelines on the use of confidential third-party information in the context of TP audits by CRA auditors.
- TPM-05R – Requests for Contemporaneous Documentation: This document cancels and replaces TPM-05 and clarifies that directive with respect to the process that must be followed by CRA auditors when requesting contemporaneous documentation pursuant to subsection 247(4) of the ITA.

- TPM-06 – Bundled Transactions: This document explains the circumstances in which the CRA will accept bundled transactions.
- TPM-07 – Referrals to the Transfer Pricing Review Committee: This document has been replaced by TPM 13.
- TPM-08 – The Dudney Decision – Effects on Fixed Base or Permanent Establishment Audits and Regulation 105 Treaty-Based Waiver Guidelines: This document provides guidelines and a general framework for permanent establishment (PE) determinations.
- TPM-09 – Reasonable Efforts under section 247 of the Income Tax Act: This document provides guidance as to what constitutes reasonable efforts to determine and use arm's-length transfer prices or arm's-length allocations; it also provides examples of situations where taxpayers are at greater risk for a TP penalty.
- TPM-10– Advance Pricing Arrangement (APA) Rollback: This document has been replaced by TPM-11.
- TPM-11 – Advance Pricing Arrangement (APA) Rollback: This document cancels and replaces TPM-10 with respect to APA rollbacks and clarifies CRA policy regarding an APA request to cover prior tax years, sometimes referred to as an APA 'rollback'.
- TPM-12 – Accelerated Competent Authority Procedure (ACAP): This document provides guidance on ACAP, which provides for the resolution of a mutual agreement procedure (MAP) case to be applied to subsequent years.
- TPM-13 – Referrals to the Transfer Pricing Review Committee: This document replaces TPM-07 and provides guidelines for referrals by CRA auditors to the International Tax Directorate and the Transfer Pricing Review Committee (TPRC) regarding the possible application of the penalty under subsection 247(3) of the ITA or the possible recharacterisation of a transaction pursuant to paragraph 247(2)(b). The revised TPM seeks to ensure a more open dialogue with taxpayers for consistent and fair application of the TP penalties.
- TPM-14 – 2010 Update of the OECD Transfer Pricing Guidelines: This document provides an overview of the significant changes made in the 2010 version of the OECD Guidelines and the CRA's position regarding these changes.
- TPM-15 – Intra-group services and section 247 of the Income Tax Act: This document clarifies the CRA's audit policy on several audit and tax issues commonly encountered during an international audit of intra-group services.
- TPM-16 – Role of Multiple Year Data in Transfer Pricing Analyses: This document confirms the CRA's position of examining transfer prices on a year-by-year basis and distinguishes between using multiple year data for comparability purposes versus using it to substantiate a transfer price.

The CRA's guidance on 'range issues' as they arise in testing a taxpayer's (or its affiliate's) profitability was published in an article presented at the Canadian Tax Foundation 2002 Tax Conference by Ronald I. Simkover, Chief Economist, International Tax Directorate, CRA.

Secondary adjustments
For transactions occurring after 28 March 2012, TP adjustments are deemed to be a dividend paid to the related non-resident, regardless of whether the non-resident has an ownership interest in the Canadian company, pursuant to subsection 247(12) of the ITA. As a deemed dividend, the amount is subject to withholding tax (WHT) as high as 25%, which could be reduced under the relevant treaty. The amount of the deemed dividend and associated WHT can be reduced, at the Minister's discretion if the amount of the primary adjustment is repatriated to the Canadian taxpayer. In effect, subsection

247(12) combines a number of other ITA provisions that were previously relied on by the CRA to effect secondary adjustments (i.e. subsections 15(1), 56(2), 212(2) and paragraph 214(3)(a)).

Reporting requirements relating to transfer pricing

Subsection 231.6 – Foreign-based information or documentation

The CRA may formally serve notice requiring a person resident or carrying on business in Canada to provide foreign-based information or documentation where this is relevant to the administration or enforcement of the ITA. Such notices must set out the time frame for production, a reasonable period of not less than 90 days. Supporting documents for inter-company charges and TP are prime examples of the types of information likely to be formally required. Information or documentation not produced following the delivery of the notice may not be used as a defence against a later reassessment. Taxpayers can bring an application to have the requirement varied by a judge. Failure to provide the information or documentation may lead to possible fines or possible imprisonment as discussed in subsection 238(1). In a 2003 decision, the Tax Court of Canada (TCC) prohibited GlaxoSmithKline Inc. from submitting foreign-based documents as evidence at trial because the documents had not been provided to the CRA when it served notice. In a 2005 decision, the TCC upheld the CRA's right to request such documentation from Saipem Luxembourg, S.A. (*See also the Soft-Moc decision, below, where the Federal Court of Canada dismissed the taxpayer's application for a judicial review of the CRA's request for f0reign-based documentation.*)

Section 233.1 – Annual information return: non-arm's-length transactions with non-resident persons

Persons carrying on business in Canada are required to file Form T106, Information Return of Non-Arm's-length Transactions with Non-Residents, to report transactions with related non-residents. For every type of transaction it is necessary to identify the TP methodology used.

The form also asks for the North American Industrial Classification System (NAICS) codes for the transactions reported, whether any income or deductions are affected by requests for competent authority assistance or by assessment by foreign tax administrations, and whether an APA in either country governs the TP methodology.

A separate Form T106 is required for each related non-resident that has reportable transactions with the Canadian taxpayer. Each asks if contemporaneous documentation has been prepared for transactions with that related non-resident. The CRA imposes late-filing, failure to file and false statement or omission penalties with respect to these forms.

A *de minimis* exception removes the filing requirement where the total market value of reportable transactions with all related non-residents does not exceed CAD 1 million.

Foreign reporting requirements

Canadian residents are required to report their holdings in foreign properties and certain transactions with foreign trusts and non-resident corporations. Significant penalties are assessed for failure to comply with these rules.

Section 233.2 – Information returns relating to transfers or loans to a non-resident trust
Generally, amounts transferred or loaned by a Canadian resident to a non-resident trust or to a company controlled by such a trust must be reported annually on Form T1141. The filing deadline generally depends on whether the Canadian resident is an individual, corporation, trust or partnership.

Section 233.6 – Information return relating to distributions from, and indebtedness to, a non-resident trust
A Canadian resident that is a beneficiary of a non-resident trust and is either indebted to, or receives a distribution from, such trust must report such transactions on Form T1142.

Section 233.3 – Information return relating to foreign property
Form T1135 should be filed where the cost of the Canadian resident taxpayer's total specified foreign property exceeds CAD 100,000 at any time in the year. The foreign property definition is comprehensive. Specific exclusions from the definition include personal assets (e.g. condominiums), property used exclusively in an active business and assets in a pension fund trust.

Section 233.4 – Information return relating to foreign affiliates
Where a person (including a corporation) or a partnership resident in Canada has an interest in a corporation or trust that is a foreign affiliate or a controlled foreign affiliate, the person or partnership is required to file an information return (Form T1134A or T1134B) for each such corporation or trust. Financial statements of the corporation or trust must also be submitted. The filing deadline for these information returns is 15 months after the tax year-end of the person or partnership.

Treaty-based disclosure
Any non-resident corporation carrying on business in Canada that claims a treaty-based exemption from Canadian tax must file a Canadian income tax return together with Schedules 91 and 97. This filing will identify those non-resident companies that are carrying on business in Canada without a PE.

Other rules and regulations

Intragroup services (management fees)
For intragroup service fees to be tax-deductible in Canada, a specific expense must be incurred and the expense must be reasonable in the circumstances. There should also be documentary evidence to support the amount of the charge, such as a written agreement to provide the services and working papers evidencing the expense charged.

Intragroup service charges are governed by section 247 of the ITA; there is no specific TP legislation for intragroup service fees, though the CRA's position on this issue is addressed in IC 87-2R and TPM-15. The WHT legislation in section 212 of the ITA provides insight into what constitutes intragroup services.

Qualifying cost-contribution arrangements
Qualifying cost-contribution arrangements provide a vehicle to share the costs and risks of producing, developing or acquiring any property, or acquiring or performing any services. The costs and risks should be shared in proportion to the benefits that each participant is reasonably expected to derive from the property or services as a

result of the arrangement. Where a participant's contribution is not consistent with its share of expected benefits, a balancing payment may be appropriate.

Penalties

Transfer pricing penalty provisions may apply where the CRA has made TP adjustments, which can result from the following circumstances:

- A net increase in income or a net decrease in loss.
- A reduction in the taxpayer's tax cost of non-depreciable and depreciable capital property and eligible capital property.

These TP adjustments are liable to a 10% penalty, subject to the following exceptions:

- Where the net TP adjustment does not exceed the lesser of 10% of the taxpayer's gross revenue and CAD 5 million.
- Where the taxpayer has made reasonable efforts to determine that its prices are arm's length, to use those prices, and to document such on or before the date its tax return is due for the taxation year. Taxpayers must be able to provide this documentation to the Minister within three months of a request.

The legislation allows favourable adjustments to reduce unfavourable adjustments when determining the amount subject to penalty. However, to obtain a set-off, taxpayers must have documentation supporting the transaction to which the favourable adjustment relates and the Minister's approval of the favourable adjustment; taxpayers without contemporaneous documentation cannot benefit from set-offs.

TPM-09 provides additional guidance on what constitutes reasonable efforts to determine and use arm's-length transfer prices. According to TPM-09, a reasonable effort is defined as 'the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances'. Further, the CRA considers a taxpayer to have made reasonable efforts when it has 'taken all reasonable steps to ensure that [its] transfer prices or allocations conform to the arm's-length principle'.

Canada's penalties are based on the amount of the TP adjustment and can apply when the taxpayer is in a loss position, such that no increased taxes are payable as a result of the adjustment. In the event of capital transactions, the penalty applies to the taxable portion of any gain. Each case where a penalty may apply is referred to the TPRC, which makes a determination as to whether reasonable efforts were made.

Interest (at rates prescribed by the CRA) is charged on the underpayment of income-tax liabilities and WHT. This interest is not deductible for income-tax purposes. Interest is not charged on TP penalties unless the penalty is not paid within the required time frame.

Risk transactions or industries

Although the CRA may not be targeting any particular industry for TP audits, it continues to develop an industry-based audit approach by developing tax service offices (TSOs) that have expertise in specific industries including pharmaceutical (TSO in Laval, Quebec), automotive (Windsor, Ontario), banking (Toronto, Ontario) and oil

and gas (Calgary, Alberta). It is not yet known whether this approach will be extended to other industries. Over time, the CRA is expected to become more consistent in its approach to TP audits in these industries and to develop national industry-specific audit procedures. The CRA also has a team of specialists in Ottawa that are focused on the TP analysis of related-party financial transactions.

Specific transactions scrutinised by the CRA include intragroup services, inter-company debt, interest charges, guarantee fees, royalty payments, intellectual property (IP) migration, contract manufacturing arrangements and restructuring and plant closures. The CRA continues to pay close attention to transactions involving IP, which are routinely referred to the CRA's specialist teams in Ottawa for review. The CRA is active in reviewing head-office charges made to subsidiaries, both outbound by Canadian parent companies and inbound to Canadian subsidiaries. Controversy on the calculation of an arm's-length price for services can arise from the definition of shareholder costs, the inclusion (or not) of stock-based compensation expense in the service cost base, and the treatment of government incentives in computing the service cost base.

The CRA has an aggressive international tax planning (AITP) division, which is part of the International and Large Business Directorate. The AITP initiative is aimed at identifying and responding to international transactions that may be designed to avoid paying income tax in Canada.

Documentation

The CRA continues to pursue a relatively aggressive programme of TP enforcement. Any TP adjustment may be subjected to a 10% penalty, with some de minimis exceptions, unless the taxpayer has made reasonable efforts to determine and use arm's-length prices. This requires contemporaneous documentation to be on hand when the tax returns for the year are due (i.e. six months after the end of the taxation year for corporations) and submitted to the CRA within three months of a written request.

As a minimum, the taxpayer should have a complete and accurate description of the following:

- The property or services to which the transaction relates.
- The terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction.
- The identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into.
- The functions performed, property used or contributed and the risks assumed in respect of the transaction by the participants in the transaction.
- The data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.
- The assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocation of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

Where contemporaneous documentation has been prepared for a prior year, the ITA provides that only those items that pertain to a material change in respect of a TP transaction must be addressed.

Statute of limitations

The statute of limitations for most taxpayers is four years. However, transactions with related-non-resident persons can be subject to audit for up to seven years after the tax year is initially assessed. In the rare situation where an audit may take longer, the CRA can ask the taxpayer to sign a waiver to extend beyond the seven years, which must be signed within the seven-year period. The CRA has stated that it is committed to timely reviews and audits.

The appropriate tax treaty should be consulted, as treaties often include a provision whereby a taxpayer must be reassessed or the competent authority of the other state notified (the US and the UK) within a specified period in order to preserve its right to request competent authority assistance in the event of double taxation. Such a reassessment can be raised regardless of whether the audit is completed.

Transfer pricing controversy and dispute resolution

Tax audit procedures

Selection of companies for audit

The CRA has changed the way it selects files for audit with the introduction of a risk-assessment approach that targets taxpayers considered to have the highest risk of non-compliance. This model focuses not only on corporations but on partnerships and trusts as well. There are three categories: 'High' (will be audited), 'Medium' (may dictate a restricted audit related to specific concerns) and 'Low' (unlikely to be audited pending future evaluations). Sources of information used to determine which category a taxpayer falls into include (but are not limited to) the following:

- The taxpayer's history of compliance.
- Data gathered from internal databases created from information required to be filed by law.
- Information received from tax treaties and tax information exchange agreements signed with other countries and provinces.

Provision of information and duty to cooperate with tax authorities

Sections 231.1 to 231.5 of the ITA provide guidance on the authority of a person authorised by the Minister in regard to an audit. Basically, the rights of an auditor are far-reaching and taxpayers are expected to cooperate. As discussed earlier, section 231.2 authorises an auditor to issue a requirement for information that the taxpayer has not readily provided.

As discussed earlier, section 231.6 of the ITA requires that foreign information or documents that are available or located outside Canada be provided to the CRA if relevant to the administration or enforcement of the ITA.

Transfer pricing audit procedure

The risk-assessment approach also applies to TP audits, which can be initiated in two ways: as part of a regular corporate audit (where TP may be included in the audit at the discretion of the audit case manager) or when a local international tax auditor screens a file solely for a TP audit, primarily using Form T106.

CRA auditors are required to provide a taxpayer with a written request for contemporaneous documentation at the initial contact stage of a TP audit. The documentation must be provided within three months of the date of service of the request. Canada's TP legislation offers no opportunity to negotiate an extension of the three-month deadline; the time frame is specified in the ITA and is not discretionary. If the deadline is not met, the taxpayer will be deemed not to have made reasonable efforts to determine and use arm's-length transfer prices and may be subject to penalty if any resulting adjustment exceeds the legislated penalty threshold.

After the CRA has received the contemporaneous documentation, the auditor usually visits the taxpayer's premises (and in some cases the premises of the non-resident-related party) to confirm the information provided. In some circumstances, the auditor may determine that the taxpayer is low risk and not proceed further.

Throughout the audit process, the auditor can refer the case to the CRA's head office to obtain technical assistance from economists. Head-office referrals are mandatory for royalties and cost-sharing arrangements.

Reassessments and the appeals procedure

Many TP issues can be resolved with the field auditor or the auditor's supervisor based on information provided and discussions held during the audit. If an issue cannot be resolved, the CRA issues a Notice of Reassessment for tax owing, based on its audit findings. At this stage, a taxpayer may have two options. The first is to pursue the issue through the CRA's appeals' division and possibly the Canadian tax courts. The second is to request relief from double taxation through the competent authority process (available only if the TP reassessment involves a related entity in a country that has a tax treaty with Canada).

In either case, the taxpayer should file a Notice of Objection. This Notice must be filed within 90 days of the date of mailing of the Notice of Reassessment and can either initiate the appeal process (if that is the desired option), or be held in abeyance (at the taxpayer's request) while the taxpayer pursues relief through the competent authority process. If the taxpayer pursues the appeal process and is not satisfied with the result, it may seek a resolution in court. If the taxpayer pursues relief through the competent authority process, the Notice of Objection will protect the taxpayer's rights of appeal in the event that the issue is not resolved through this process.

A taxpayer can request competent authority assistance after it has proceeded through the appeal process and/or obtained a decision from a court. However, in its dealings with the foreign competent authority the Canadian competent authority is bound by any settlement with the CRA's appeals division or a court decision. Whether relief from double taxation is provided is at the sole discretion of the foreign competent authority.

A large corporation (as defined under the ITA) is required to remit 50% of any amounts owing to the federal government as a result of the reassessment (tax, interest and penalties) while appealing the Notice of Reassessment. In the case of WHTs and provincial taxes, the full amount must be remitted.

Burden of proof

Under the Canadian taxation system, the taxpayer makes a self-assessment of tax that is then assessed by the CRA (either with or without an audit). In the event of an audit, the onus is on the taxpayer to satisfy the tax authorities that transfer prices are arm's length.

The TP legislation also requires that the taxpayer show that it has made reasonable efforts to determine and use arm's-length transfer prices in order to exclude any related adjustments from penalty.

Case law

McKesson Canada Corporation (2013)

The primary issue in this case was a TP adjustment made by the CRA to McKesson Canada Corporation's (MCC's) income, related to trade receivables factoring transactions involving MCC and its immediate parent MIH, a company resident in Luxembourg, pursuant to a receivables sales agreement (RSA) in which the latter agreed to purchase certain of MCC's receivables at a discount of 2.206% from the face amount.

The Court accepted the legal structure of the RSA but disagreed that the terms and conditions that affected the discount rate were arm's length; it found that the discount rate was too high and agreed with the CRA's adjustments.

After considering each component of the discount rate and making various adjustments, the Court concluded that the appropriate discount rate was between 0.959% and 1.17%. As the discount rate under the RSA exceeded this range and CRA's rate of 1.013% was within it, the Court rejected the taxpayer's position.

Also of note, the Court made a number of comments related to TP that did not bear on the decision but that are of general interest to taxpayers including the relevance of the OECD Guidelines in court proceedings; the relevance of the series of transactions that relate to the transaction; and the requirement of the taxpayer to consider all options available to it in setting its TP.

The taxpayer is appealing the decision.

Soft-Moc (2013)

At issue in Soft-Moc was whether the taxpayer had to provide a number of documents requested by the CRA during a TP audit including those involving related parties the taxpayer did not transact with, as well as other documents the taxpayer claimed were irrelevant, confidential or inaccessible. The Federal Court of Canada found for the Minister and the CRA, holding that all documents requested were necessary for the audit, noting that while such requests "need to be both relevant and reasonable….the threshold is low and the powers of the Minister are wide-ranging."

GlaxoSmithKline (2012)

This case was the first TP case to be heard by the Supreme Court of Canada (SCC). At issue was whether the price paid by a pharmaceutical manufacturer to a related party for an ingredient used in a top selling drug was too high, even though it could be sold using a licensed brand. In its decision, the Court held that when determining transfer prices, significant factors that arm's-length parties would likely consider, such as the licence agreement in this case, must be taken into account. The SCC referred the case back to the Tax Court of Canada (TCC) for retrial, with each party permitted to provide new evidence with respect to pricing. The case was settled before the retrial.

Alberta Printed Circuits Ltd. (2011)
In this case the TCC found in favour of the taxpayer, Alberta Printed Circuits, Ltd. (APCI Canada), in respect of the application of the comparable uncontrolled price (CUP) method to determine arm's-length set-up service fees paid to a related company in Barbados (APCI Barbados). However, despite the TCC's rejection of the CRA's analysis supporting its reassessments, it substantially disallowed the fees paid by APCI Canada to APCI Barbados for other services. While the TCC found that there was an absence of any compelling evidence to show the arm's-length nature of the charge for these other services, it nonetheless computed a charge for the services that left a significant portion of the CRA's reassessments in place.

General Electric Capital Canada (2010)
This case involved the deductibility of guarantee fees paid by a subsidiary to its parent. General Electric Capital Canada Inc. (GECC) deducted millions in guarantee fees it paid to its US-based parent company for explicitly provided financial guarantees, which were disallowed on the basis that the fees provided no value to the taxpayer. The TCC found for the taxpayer, holding that the 1% guarantee fee paid was equal to or below an arm's-length price and that the implicit support derived from GECC being a member of the GE family was a relevant factor that should be considered as part of the circumstances surrounding the transaction.

On appeal, the Court discussed the objective of TP legislation, 'which is to prevent the avoidance of tax resulting from price distortions which arise in the context of non-arm's-length relationships,' and stated that 'the elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective'. In this case, because implicit support is a factor that an arm's-length person would find relevant in pricing a guarantee, Canada's Federal Court of Appeal (FCA) held that it had to be considered, and that ignoring it would be turning 'a blind eye on a relevant fact and deprive the TP provisions of their intended effect.'

Double taxation and competent authority proceedings
Two articles in Canada's income-tax treaties are relevant to TP.

- The Associated Enterprises article (Article 9) provides a definition of related parties for the purpose of the treaty and provides that each State can make adjustments to related-party transactions based on the arm's-length principle. Certain treaties may stipulate a time limit to make application for assistance under this article. In the absence of a timeline, the time provided under domestic legislation prevails.
- The MAP article (Article 25) states that the competent authorities shall endeavour to resolve any taxation (e.g. double taxation) that is not in accordance with the treaty.

A taxpayer does not need to wait for the issuance of a Notice of Reassessment before filing a request for competent authority assistance. However, the competent authority will not act on the request until a reassessment has been issued.

The competent authority process for a Canadian taxpayer that has been reassessed can be summarised as follows. The non-resident-related party must file a request for competent authority assistance (complete submission) in its country of residence within the time frame provided in the treaty. A similar request is normally filed simultaneously with the Canadian competent authority by the Canadian resident. The foreign competent authority informs the Canadian competent authority that it

has received the request and requests a position paper outlining the details of the reassessment. The Canadian competent authority obtains the auditor's working papers (including additional information provided by the Canadian taxpayer), reviews the case and, if unable to unilaterally resolve the double taxation, provides the position paper to the foreign tax administration, after which negotiations between the competent authorities take place to resolve the double taxation. Once the competent authorities reach agreement, they advise the taxpayers in their respective countries of the proposed settlement. Once the taxpayers have accepted the proposed settlement, the necessary adjustments are processed in each country.

As the timing for filing a competent authority request varies by treaty, it is important to consult the MAP article of the relevant treaty. Generally, the competent authority submission must be filed within two years of the date of the Notice of Reassessment.

Canada currently has two treaties in which the Associated Enterprises article requires that the other competent authority be notified of potential double taxation within six years of the end of the taxation year under audit. Once notification is provided, the MAP articles in those treaties do not impose a time frame within which the competent authority submission must be filed.

If a request for competent authority assistance with a submission or notification is not filed on time, a taxpayer may be denied relief by the competent authority of the non-resident-related party.

The CRA's Competent Authority Services Division is responsible for the competent authority function as it pertains to the MAP and Exchange of Information articles in the treaties. Case officers in this division meet quarterly with their US counterparts and occasionally with governments of other foreign jurisdictions to discuss specific cases.

An amendment to the Canada-US treaty providing for binding arbitration in MAP cases was ratified on 15 December 2008, and a memorandum of understanding (MoU) regarding the conduct of these arbitration proceedings was released on 26 November 2010. The MoU establishes the procedures for arbitration cases and indicates that the two countries have resolved their differences regarding the scope of the treaty's arbitration provision, the types of cases eligible for arbitration and the manner in which issues will be resolved in arbitration proceedings. The process is described as 'baseball' arbitration, i.e. the arbitration board (comprising three members) selects one of the proposed resolutions provided by the competent authorities as its determination.

Arbitration may be invoked by the taxpayers only on filing the required non-disclosure agreements. Generally, such agreements can be filed two years after the competent authorities have agreed they have received a complete submission to resolve the case.

TPM-12, Accelerated Competent Authority Procedure, provides guidance on this process, which provides that the issues that gave rise to a MAP case may be addressed by the competent authorities in subsequent years at the taxpayer's request.

The CRA's MAP programme report for 2014 includes the following highlights:

- A total of 2,952 new cases were accepted during the year, with 2,923 completed.
- Of new cases accepted, 127 were categorised as 'negotiable' (i.e. involving another tax administration).
- Of the 2,923 cases in inventory that were completed, 105 were negotiable.
- The average time to complete the Canadian-initiated cases was 23 months, while the foreign-initiated completed cases took an average of 31 months.
- Full relief was granted in 98% of the negotiable cases, partial relief was granted in no cases and no relief was granted in 2% of the cases.

Advance pricing arrangements (APAs)

The APA programme is intended to assist Canadian taxpayers in determining acceptable TP methodology and provide certainty on covered transactions. An APA is intended to consider proposed pricing arrangements or methodologies that have prospective application and is designed to seek agreement on an appropriate TP methodology for a specified cross-border transaction between related parties. The service is offered in addition to competent authority assistance on the appropriateness of historic transactions that have been challenged by one or both jurisdictions involved.

APAs can be unilateral, bilateral or multilateral. At the conclusion of the procedure, there is a binding agreement between the taxpayer and the CRA and, in the case of bilateral or multilateral APAs, between the CRA and the other tax authorities involved. Procedures and guidelines for obtaining APAs in Canada are outlined in IC 94-4R.

The CRA has established the following policies regarding the rollback of TP methodologies agreed upon through the APA process:

- A rollback will be considered if a request for contemporaneous documentation has not been issued by the CRA, the facts and circumstances are the same, and both the foreign tax administration and the CRA agree to accept the APA rollback request.
- A waiver must be filed for each year in question in accordance with the ITA.
- Once an APA is in force, transactions occurring in tax years covered by the APA and the rollback period are not subject to a TP penalty.
- The CRA will not issue a request for contemporaneous documentation for transactions in a year that a taxpayer has requested to be covered by an APA rollback at a pre-filing meeting.
- An APA rollback will not be permitted when a taxpayer requests a unilateral APA.

The first year of a unilateral APA will be the first taxation year for which a tax return has not been filed that includes the agreed-to TP methodology.

Due to ongoing staffing shortages in the competent authority division, the CRA has implemented the following changes to the APA programme:

- CRA case officers must present a business case to the competent authority with respect to the necessity of site visits.
- There is reluctance to accept requests for a unilateral APA.
- The CRA is relying increasingly on the taxpayer to provide analyses the CRA would normally undertake.
- The pre-filing package must be submitted to the CRA and deemed complete by the CRA before a pre-filing meeting is scheduled.

- At the pre-filing meeting, there is increased scrutiny concerning the viability of a taxpayer to enter the APA programme. Additional information may be requested by the CRA before and/or after the pre-filing meeting.

The 2014 annual report on the APA programme published by the CRA reports the following:

- Thirty-nine cases were accepted into the programme.
- The active case inventory was 99 cases.
- Twenty-five cases were completed, of which 23 were bilateral/multilateral and two were unilateral.
- Of the completed cases, bilateral APAs took an average of 47.8 months to complete, while unilateral APAs took an average of 46.2 months to complete.
- The transactional net margin method (TNMM) continues to be the predominant methodology used in APAs (50% of completed and in-progress cases), followed by the profit split (PSM) (18% of completed and in-progress cases) and the cost plus (CP) method, at 13%.
- When the TNMM is used, the most common profit level indicator used is the operating margin (used 61% of the time), followed by total cost plus (27% of the time) and the Berry ratio and return on assets (combined, 12% of the time).

Joint audits
Most tax treaties have exchange-of-information provisions including a provision for joint audits. Canada and the US have an agreement in place for joint audits. Both groups of auditors on complex audits initiate these reviews to minimise the time and effort.

Comparison with OECD Guidelines
Canada is a member of the OECD and its TP legislation conforms with the OECD Guidelines. As noted above, the CRA's TPM-14 specifically endorses the revised OECD Guidelines issued on 22 July 2010, which address a number of issues concerning comparability as well as business restructuring. Further, on 26 June 2012, the governments of the US and Canada entered into an agreement to follow the Authorized OECD Approach for determining the amount of profit to attribute to a PE, which allows profits to be established for a PE regardless of whether the enterprise as a whole shows a profit or loss.

Canada

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Chile

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Overview

Over the last couple of years, Chile has been experiencing significant changes regarding transfer pricing (TP), which have been changing the way local taxpayers view their inter-company transactions.

Even though Chilean TP legislation was introduced in 1997, being among the first in the region, Article 38 of the Chilean Income Tax Law seemed to be insufficient, since it did not include relevant technical matters, such as detailed description of the TP methods, nor did it incorporate internationally accepted practices on this matter.

Taking into consideration this background in the Chilean TP legislation, and facing the need for greater funding of public education – a topic that had caused social unrest – on 30 April 2012, President Sebastian Piñera sent to the Parliament a comprehensive bill that introduces major changes to the Chilean tax system.

On 27 September 2012, the new Article 41 E of the Income Tax Law entered into force, introducing significant changes in Chilean TP legislation. The main changes introduced by the new TP legislation are the following:

- Introduction of the Organisation for Economic Co-operation and Development (OECD) TP methods.
- Requirement to file an annual informative return regarding inter-company transactions and penalties for non-compliance.
- Introduction of an advance pricing agreement (APA) programme.
- Possibility to request corresponding adjustments.

Additionally, the Chilean Internal Revenue Service (Chilean IRS) issued Resolution No. 14, which establishes the obligation to file an annual TP informative return, and Circular No. 29 of 2013, which extends certain concepts in this matter.

Moreover, on 29 October 2012, the Chilean IRS, issued resolution No. 115, which states that taxpayers who celebrate derivative contracts with related parties, must have a technical memo, at the disposal of the Chilean IRS, containing the necessary elements to demonstrate that such contracts have been agreed under arm's-length conditions. The rule is applicable to all those derivative contracts agreed with related parties since

commercial year 2012 or that have otherwise been modified during commercial year 2012 or the applicable year post-2012.

Over the last couple of years, the Chilean IRS has actively performed TP audits to a significant number of taxpayers. Currently, there are several TP audit programmes being implemented by the Chilean IRS. There is evidence of TP audits to mining companies, retailer companies, the fruit industry and pharmaceuticals groups, among others.

Finally, Chile has entered a path of no return regarding TP, which will imply that Chilean taxpayers will have to be more careful when performing inter-company transactions, in order to avoid possible risks on this relevant tax area.

Country	**Chile**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes (*)
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared? (*)	Even though TP studies are not required to be filed on an annual basis before the local IRS, such documentation must be prepared and ready to be presented to the authorities in the context of a TP audit, in order for the local taxpayer to demonstrate and prove the fulfilment of the arm´s-length principle for the inter-company transactions under review. Such requirement would make TP documentation necessary to be prepared on a contemporaneous basis, since the taxpayer will only have 30 days to prepare such TP documentation once requested by Chilean IRS.
Must TP documentation be prepared in the official/local language?	No, although it is recommended to prepare it in Spanish.
Are related-party transactions required to be disclosed on the tax return?	Yes, an annual TP return must be filed by June every year.
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes. There are also fines for not filing correctly the annual informative return.

Country	Chile
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	If the Chilean IRS performs a TP adjustment in the context of a TP audit, the difference determined will be affected in the applicable year, with the Sole Tax mentioned in the first paragraph of Article 21 of the Income Tax Law (sole tax of 35%), plus interests and readjustments that apply. Furthermore, it is feasible to apply a penalty equal to 5% of the amount of that adjustment in particular cases. The Law establishes the application of penalties for not filing the annual informative return, for filing it out of date or with incorrect/incomplete information. These penalties could range from 10 up to 50 annual tax units (between 10,000 and 50,000 United States dollars [USD] approximately).

Introduction

Article 22 of Law 19,506, published in the Official Gazette on 30 July 1997, introduced four paragraphs to Article 38 for the Income Tax Law, which used to contain the Chilean TP rules. A minor amendment to these regulations was introduced by Law 19,840, published in the Official Gazette on 23 November 2002. These paragraphs had the basic TP regulations in Chile. A minor amendment of these regulations was introduced by Law 19,840, published in the Official Gazette on 23 November 2002.

In addition, the Chilean IRS, the Chilean Tax Authority, issued circulars N°3 and N°57 in 1998 and N°72 in 2002. These circulars contain guidelines for the implementation of regulations by the tax inspectors.

On 30 April 2012, the President of the Republic of Chile sent to the Parliament a tax bill that includes Article 41 E to the Income Tax Law. The said article introduces specific TP legislation.

On 27 September 2012, the new Article 41 E of the Income Tax Law entered into force, introducing significant changes in Chilean TP legislation. The main changes introduced by the new TP legislation are the introduction of the OECD TP methods, requirement to file an annual informative return regarding inter-company transactions and penalties for non-compliance, introduction of an APA programme and the possibility to perform corresponding adjustments.

Additionally, the Chilean IRS issued the Resolution No. 14, which establishes the obligation to file an annual TP informative return, and the Circular No. 29 of 2013 which extends certain concepts in this matter.

Chile

Legislation and guidance

The Chilean transfer pricing regulations

Scope of rules

The new TP Article 41 E of the Income Tax Law adheres, in general, to the OECD TP Guidelines. The new TP legislation allows the Chilean tax authority to challenge prices, values or profitability on transactions under the following circumstances:

- Transactions with foreign-related parties.
- Transactions derived from business restructurings and reorganisations that imply the shift of goods or activities able to generate taxable income to tax havens or preferential tax regimes.
- Transactions carried out with entities resident in countries included in a list of tax havens, or preferential tax regimes with whom Chile has not entered into an exchange of information agreement.

Considering the Chilean legislation, it is important to bear in mind that even though the TP legislation is conceived for cross-border transactions, Article 64 of the Chilean Tax Code gives the Chilean IRS the faculty to assess the price or value of local transactions between related parties.

The concept of related entity

For the purposes of section 41 E, the parties are considered related if:

- One of them participates directly or indirectly in the management, control, profits or revenues of the other entity.
- A person or persons participate directly or indirectly in the management, control, capital, profits and revenues of the other party.
- A person or persons participate directly or indirectly in the management, control, capital, profits and revenues of both parties, meaning all interrelated.
- The agency, branch or any other form of permanent establishment (PE) with: i) its headquarters, ii) with other PEs of the same parent, iii) related parties of the headquarters, and iv) PEs of the headquarters.
- It will be considered that there is a relationship between the participants when a party conducts one or more transactions with a third party who, in turn, carries out, directly or indirectly, similar or identical transactions with parties related to the latter.

Also, related parties are considered when the transactions are carried out with entities' residents, domiciled, established or incorporated in countries or territories considered tax havens or harmful preferential tax regimes included in the list referred to in No.2 of the Article 41-D, unless that country or territory has signed an agreement with Chile allowing the exchange of information.

Methods

Although current Chilean TP legislation does not explicitly refer to the OECD Guidelines, the methods included in the new TP regulations are in line with the methods described in such Guidelines. The law also adopts the most appropriate method rule and allows the use of other unspecified methods when the methods described in the Income Tax Law are not considered appropriate for determining the arm's-length principle in inter-company transactions.

The methods included in the Chilean TP legislation are the following:

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Profit split method
- Transactional net margin method
- Residual methods

Formal requirements: Documentation and informative transfer pricing return
Pursuant to Chilean Income Tax Law, taxpayers are required to keep all the information that supports the application of a TP method allowed by the Chilean Income Tax Law. Transfer pricing documentation must be contemporaneous with the tested transactions, since it should be available to the Chilean tax authority within 30 days of being requested.

Additionally, the taxpayers are required to file an annual informative return regarding cross-border inter-company transactions.

Deadline
The deadline for filing the informative return is the last working day of June each year.

Taxpayers obliged
Taxpayers listed below must submit to the Chilean IRS, Form No. 1907 – 'Transfer Pricing Annual Informative Return':

- Taxpayers that belong to the segments of medium or large companies and that carried out cross-border inter-company transactions during the applicable year.
- Taxpayers, other than those classified by the Chilean IRS as medium or large companies, which during the applicable year carried out transactions with persons domiciled or resident in countries or territories considered tax havens or preferential tax regimes.
- Taxpayers, other than medium and large companies, which during the applicable year carried out transactions with foreign-related parties for amounts exceeding 500,000,000 Chilean pesos (CLP) (approx. USD 1,000,000), or its equivalent, according to the foreign currency.

Penalties
Among other relevant penalties that can be triggered under certain circumstances, failure to file the TP Annual Informative Return in the time and manner established by the Chilean IRS will be sanctioned with a penalty of between USD 10,000 and USD 50,000.

Content
Besides reporting specific information, the TP Annual Informative Return requires detailed information per type of transaction: tangible transactions, financing transactions, operations arising from the use of intangible assets, rendering of services or commissions, and commercial accounts. Additionally, information about the TP method applied by local taxpayers in validating the arm's-length value for each type of transaction will be required.

Finally, it is noteworthy that this ruling incorporates relevant aspects of TP to be considered in light of the circumstances of each taxpayer involved.

Corresponding adjustments
Under the new TP provisions, taxpayers have the ability to perform TP corresponding adjustments, but they have to be authorised by the Chilean IRS and can only be allowed in cases that involve a country with which Chile has a double tax treaty (DTT) in force. The tax authority can agree to the corresponding adjustments only when the filing date of administrative or litigation procedures has not expired. Moreover, the adjustment must be based on the application of one of the TP methods allowed in the Income Tax Law, among other requirements.

Advance pricing agreement (APA) programme
Article 41E of the Chilean Income Tax Law includes the possibility to enter into APAs (unilateral or multilateral) with local and foreign tax authorities. The Chilean tax authority can reject, totally or partially, the request and such decision would not be subject to an administrative appealing procedure. APAs would be valid for three years and are subject to renewal or extension. Tax authorities can nullify APAs when the request of the taxpayer is based on false statements or when there is a significant change in the facts and circumstances under which the APA was granted.

Additionally, the Chilean IRS issued Resolution No. 68, which establishes the background to be accompanied with the APA request, the content of the TP report and processing time of the request, among other issues.

The Chilean derivative contracts regulations
On 29 October 2012, the Chilean IRS issued resolution No. 115, which states that taxpayers who celebrate derivative contracts with related parties must have a technical memo at the disposal of the Chilean IRS, containing the necessary elements to demonstrate that such contracts have been agreed under arm's-length conditions.

The rule is applicable to all those derivative contracts agreed with related parties since commercial year 2012, or that have otherwise been modified during commercial year 2012 or the applicable year post-2012.

For purposes of this obligation, the definition of related parties is quite broad and this refers to Article 100 of the Securities Market Law, which might not coincide with the definition of related parties for the purposes of TP regulations included in our Income Tax Law.

The technical memo requested by the Chilean IRS must contain, at least, the following:

- A detailed description of the derivative operation, pointing out, among other things, the type of contract, the parameters used to determine its price or value, duration of the contract and the subjacent asset/liability that it is covering for as the case may be.
- The economic circumstances that gave place to the celebration of the contract.
- An analysis of comparable transactions, as well as the methodology used for selecting the comparables. Likewise, it shall indicate the price or value that the taxpayer believes to be arm's length for a given contract.

If the information contained in the technical memo is found insufficient by the Chilean IRS (i.e. the IRS considers that it does not support the arm's-length conditions of a given operation), adverse tax consequences will be triggered to the local taxpayer.

Finally, is important to note that on 29 October 2012, the Chilean IRS issued resolution No. 114, which established three new sworn affidavits (DJ 1820, 1829 and 1839) that will indeed serve as base information for assessing derivative operations and the fulfillment of the tax law in general.

Penalties

If the Chilean IRS performs a TP adjustment in the context of a TP audit, the difference determined will be affected in the applicable year, with the sole tax mentioned in the first paragraph of Article 21 of the Income Tax Law (sole tax of 35%), plus interest and readjustments that apply. Furthermore, it is feasible to apply a penalty equal to 5% of the amount of that adjustment in particular cases.

Nevertheless, the Law establishes the application of penalties for not filing the annual informative return, for filing it out of date or with incorrect/incomplete information. These penalties could range from 10 up to 50 annual tax units (between USD 10,000 and USD 50,000 approximately).

Documentation

Transfer pricing documentation

Pursuant to the new legislation, taxpayers are required to keep all the documentation that supports the application of a TP method allowed by the Chilean Income Tax Law. Transfer pricing documentation must be contemporaneous with the tested transactions and it should be available to the Chilean tax authority within 30 days of being requested.

Even though the development of a TP study is not mandatory for Chilean taxpayers, it would allow for adequate support of the market value of the Company's controlled transactions, in the context of a possible TP audit by the Chilean IRS.

Derivatives technical memo

The Chilean IRS, issued resolution No. 115, which states that taxpayers who celebrate derivative contracts with related parties must have a technical memo at the disposal of the Chilean IRS, containing the necessary elements to demonstrate that such contracts have been agreed under arm's-length conditions.

The technical memo requested by the Chilean IRS must contain, at least, the following:

- A detailed description of the derivative operation, pointing out, among other things, the type of contract, the parameters used to determine its price or value, duration of the contract and the subjacent asset/liability that it is covering for, as the case may be.
- The economic circumstances that gave place to the celebration of the contract.
- An analysis of comparable transactions, as well as the methodology used for selecting the comparables. Likewise, it shall indicate the price or value that the taxpayer believes to be arm's length for a given contract.

If the information contained in the technical memo is found insufficient by the Chilean IRS (i.e. the IRS considers that it does not support the arm's-length conditions of a given operation), adverse tax consequences will be triggered to the local taxpayer.

Transfer pricing controversy and dispute resolution

Transfer pricing audits

Ever since Chile became an active member of the OECD in 2010, the Chilean IRS has been very active regarding TP and has incorporated qualified personnel with wide experience in this area. This circumstance led to a series of selective reviews by the Chilean IRS, where it was clearly perceived that a highly trained team was behind the TP audits, since the information requests (notifications and summons) and tax assessments issued by the local tax authority, demonstrated a clear understanding of the internationally accepted practices and concepts regarding TP.

As mentioned before, in the context of the Tax Reform of 27 September 2012, significant changes that modernised Chilean TP legislation were introduced by means of Article 41E of the Chilean Income Tax Law. Among other aspects, this new TP legislation incorporated the formal requirement to file by electronic means, on a yearly basis, a TP informative return, for the inter-company transactions performed on the previous calendar year (starting on commercial year 2012).

This new source of information will allow the Chilean IRS to build a database with very detailed data about the taxpayer's inter-company transactions, due to the fact that this TP return was strategically and technically developed by the Chilean Tax Authority, with the purpose of requesting very detailed information per type of transaction (tangible goods, financing transactions, intangible assets, services and current mercantile accounts). Therefore, it is expected that the Chilean IRS will use this database to perform even more specific and focused TP audits.

Over the last couple of years, the Chilean IRS has actively performed TP audits to a significant number of taxpayers. Currently, there are several TP audit programmes being implemented by the Chilean IRS. There is evidence of TP audits to mining companies, retailer companies, the fruit industry and pharmaceuticals groups, among others.

Burden of proof

There are no specific rules on the burden of proof relating to TP. However, under the general rules in the Chilean Income Tax Law, it is generally considered that the burden of proof lies with the Chilean IRS.

Advance pricing agreements (APAs)

The Chilean IRS has been very open to Chilean taxpayers requesting APAs, since new TP legislation also introduced this possibility, which has led to a series of APAs already requested by local taxpayers to the Chilean IRS, in order to be certain of the fulfillment of the arm's-length principle, from a Chilean TP perspective.

At present, there are several APAs in process, currently under review by the Chilean IRS.

Comparison with OECD Guidelines

On 11 January 2010, Chile became a member of the OECD, although the local TP regulations do not expressly recognise the standards set by the OECD Guidelines. However, the Chilean IRS has generally adopted the OECD Guidelines as general reference.

The comparison between Chilean TP rules and the OECD Guidelines are presented in the following table:

Topic	Chilean TP rules	OECD Guidelines	Comments
Arm´s-length principle	√	√	
Interquartile range		√	The Chilean TP rules do not specify the use of the interquartile range, since it only refers to this statistical tool as an example or reference that can help the taxpayers to improve the analysis's reliability.
Comparability analysis	√	√	
Transfer pricing methods	√	√	The Chilean TP rules allow the use of other unspecified methods (residual methods) when the methods described in the Income Tax Law are not considered appropriate for determining the arm's-length principle in inter-company transactions.
Most appropriate method	√	√	
Transfer pricing adjustments	√	√	
APAs	√	√	
Corresponding adjustments	√	√	
Intangible property		√	The Chilean TP rules do not provide specific guidance for intangible property matters.
Intragroup services		√	The Chilean TP rules do not provide specific guidance for intragroup services' matters.
Cost contribution arrangements		√	The Chilean TP rules do not provide specific guidance for cost contribution arrangements' matters.
Business restructuring	√	√	Even though the Chilean TP rules do not provide very specific guidance for business restructuring matters, Article 41 E of the Income Tax Law does give the Chilean IRS the faculty to review the arm´s-length nature of business restructuring between Chilean companies and foreign-related parties.

Chile

23.

China

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Overview

The China tax administration is keenly aware of issues around transfer pricing (TP) and has voiced its intention to safeguard what it views as its 'fair share' of taxes. Some remarkable developments are:

The China tax administration has endeavoured to advocate the so-called 'China position' in different international platforms, such as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN), more specifically, location-specific advantages, local intangibles, outbound payments and transparent information disclosures.

The China tax administration has strengthened its efforts to combat international tax evasion and avoidance nationwide in the context of Base Erosion and Profit Shifting (BEPS) initiatives in the globe. The enforcement effort is strongly supported by the Chinese government in line with its economic policies and nowadays is the priority of the Chinese tax authorities at different levels.

The current prevailing major TP regulation, i.e. *Guo Shui Han* [2009] No. 2 is under revision (as of 1 May 2015) and it is expected to be finalised by the end of 2015, which will likely reflect the new developments from the ongoing BEPS and UN initiatives, especially those regarding documentation, intangibles and intragroup services considerations.

The anti-tax avoidance efforts at the national and provincial/local levels have seen continued restructuring. The anti-tax avoidance resources at China's State Administration of Taxation (SAT) have doubled, and are now divided into two separate teams focusing on different tasks. In some jurisdictions, all anti-tax avoidance matters will be handled by a central team. Furthermore, the China tax administration intends to keep enforcing the so-called 'panel review' mechanism for major TP cases.

Transfer pricing audit cases from previous years revealed that the China tax administration has moved on from focusing on areas such as conventional contract manufacturing arrangements to more sophisticated matters, such as intragroup services and intragroup equity transfers, among others.

In addition, the China tax administration has been promoting the 'self-adjustment' mechanism as a useful and more 'amicable' measure to tackle any 'profit mismatch.'

Country	China
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	May 31
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Renminbi (RMB) loan base rate plus 5%

Introduction

The TP regime in China is generally consistent with the OECD Guidelines and has developed rapidly over the past few years. China's corporate income tax (CIT) law, together with its detailed implementation regulations (DIR), contains the key TP and anti-avoidance concepts that govern TP enforcement in China.

In January 2009, China's State Administration of Taxation (SAT) issued a circular, titled *Guo Shui Han* [2009] No. 2 (Circular 2), the 'Implementation Measures of Special Tax Adjustments – trial version', which provides further guidance on the above concepts.

Legislation and guidance

Statutory rules

The CIT law

The highest level of legislation in China is represented by laws enacted by the National People's Congress (NPC). The current CIT law was promulgated on 16 March 2007 by the NPC and became effective on 1 January 2008. Articles relevant to TP are found mainly in Chapter 6 – 'Special Tax Adjustment'. The CIT law stipulates that the arm's-length principle is the guiding principle for related-party transactions and empowers the tax authorities in China to adjust a taxpayer's taxable income if it fails to comply with the arm's-length principle in its dealings with related parties.

The DIR of CIT law

The second level of tax legislation is represented by detailed implementation regulations, which are promulgated by a super-ministerial organisation known as the State Council.

The DIR of CIT law, promulgated on 6 December 2007, provides more specific guidance relating to all aspects of CIT law. Regarding Chapter 6 specifically, the DIR not only expands on various concepts in CIT law (such as cost-sharing, controlled foreign corporations, thin capitalisation and general anti-avoidance), but also imposes contemporaneous TP documentation requirements and a special interest levy. These additional rules and requirements may have a significant impact on taxpayers in certain situations.

Circular 2

The third level of tax legislation is represented by circulars issued by the SAT. The formal circulars issued by the SAT are usually designated as '*Guo Shui Han*', 'SAT Public Notice' or 'SAT Order'. The SAT also issues less formal letter rulings (known as 'Guo Shui Han') which can take the form of replies by the SAT on specific issues raised to them by one of their underlying tax bureaus.

Circular 2, promulgated by the SAT in January 2009 with an effective date of 1 January 2008, lays out detailed rules on administering all the aspects covered by special tax adjustments. Circular 2 supersedes all past notices; it affirms certain prior positions while also introducing a set of new obligations.

Circular 2 also lays the foundation for future developments. In fact, the connotation that its contents are a 'trial version' (as stated in the title) provides the SAT with flexibility to issue further circulars to interpret and clarify the concepts it introduces.

Major features

Transfer pricing methods

Article 111 of the DIR lists six 'appropriate methods' for conducting TP investigations. Those six methods, which are the same as those provided in the OECD Guidelines, are as follows:

- Comparable uncontrolled price method.
- Resale price method.
- Cost-plus method.
- Transactional net margin method (TNMM).
- Profit split method.
- Other methods consistent with the arm's-length principle.

Chapter 4 of Circular 2 provides guidance on the application of each of the five specified methods. Circular 2 does not stipulate any hierarchy or preference in methods used by tax authorities during a TP audit assessment; however, it does implicitly endorse the selection of the most appropriate TP method. According to Article 22 of Circular 2, a comparability analysis should be carried out when selecting a TP method and the following five comparability factors should be taken into consideration:

- Characteristics of the assets or services involved in the transaction.
- Functions and risks of each party engaged in the transaction.
- Contractual terms.
- Economic circumstances.
- Business strategies.

Use and availability of comparable information
As directed in a tax circular prior to enactment of the new CIT law, Chinese tax authorities are encouraged by the SAT to use the information databases of the National Bureau of Statistics and Bureau van Dijk in TP audits. (Note that in recent years the SAT has subscribed to Bureau van Dijk's OSIRIS database.)

However, Article 37 of Circular 2 specifically states that both public information and non-public information (i.e. 'secret comparables') may be used by the Chinese tax authorities during TP investigations and evaluations. The CIT law and its DIR also empower tax authorities to collect relevant information (e.g. contemporaneous documentation) from potential comparable companies in the same industry during an audit. Obviously, such information cannot be obtained in the public domain.

Other relevant provisions under Circular 2 regarding the use of comparable information involve the following:

Although Circular 2 has introduced the interquartile range as a method of testing profitability, it is stated that in the context of a TP investigation, companies with profitability below the median level may still be subject to an adjustment to achieve at least the median profitability level of the comparables.

During TP investigations, the use of working capital adjustments is discouraged and would require approval from the SAT if deemed absolutely necessary.

Advance pricing arrangements (APA)
Circular 2 provides guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing and renewing APAs. In general, these provisions are a restatement of the previous rules on APAs (i.e. *Guo Shui Han* [2004] No. 118), with several modifications and amendments. The following points are worth noting:

- The SAT has specified that APAs will, in general, be applicable to taxpayers meeting the following conditions: i) annual amount of related-party transactions over RMB 40 million; ii) the taxpayer complies with the related-party disclosure requirements; and iii) the taxpayer prepares, maintains and provides contemporaneous documentation in accordance with the requirements.
- The term for an APA will cover transactions for three to five consecutive years (the previous provisions provided that APAs normally cover two to four years).
- Upon approval of the tax authorities, an APA may be rolled back (i.e. the pricing policy and calculation method adopted in the APA may be applied to the evaluation and adjustment of related-party transactions in the year of application or any prior years) if the related-party transactions in the year of application are the same as, or similar to, those covered by the APA.
- An APA will be respected by the relevant state and local tax bureaus at all levels as long as the taxpayer abides by all the terms and conditions of the APA. This can be regarded as a positive sign from the SAT to ensure certainty of APAs.
- Pre-filing meetings with tax authorities may now be held anonymously.
- While a taxpayer with an effective APA is exempted from the contemporaneous documentation requirements under Chapter 3 of Circular 2 with respect to the covered transactions, it is required to file an annual APA compliance report with the applicable local tax bureau(s) within five months of the end of each tax year.

- For bilateral or multilateral APAs, taxpayers should submit their applications (including pre-filing and formal applications) to both the SAT and the in-charge municipal or equivalent level tax authorities, simultaneously. Circular 2 also states that, where the SAT accepts an application for a bilateral or multilateral APA, the SAT will enter into negotiations with the competent authority of the treaty partner, based upon the relevant treaty's mutual agreement procedures (MAPs).
- Circular 2 states that, in the event that an APA is applied for but not ultimately reached, any non-factual information regarding the taxpayer that was gathered during the application and/or negotiation process may not be used for tax investigations.

The APA guidance under Circular 2 – in particular the introduction of the rollback provision – anonymous pre-filing meetings, and dual application at both the SAT and in-charge municipal or equivalent tax authority level (for bilateral and multilateral APAs), make China's APA programme more attractive to taxpayers through the removal of some of the uncertainty that has historically surrounded it. This guidance, together with the SAT's emphasis on services to taxpayers, demonstrates the importance and commitment that the SAT is placing on APAs and their desire to create a successful APA programme in China.

Cost-sharing arrangement (CSA)

Cost-sharing arrangements for joint development of intangibles and sharing of services are covered in Circular 2. Similar to the OECD's TP Guidelines, Circular 2 requires the following items to be contained in a CSA:

- Name of participants, their country (region) of residence, related-party relationships, and the rights and obligations under the agreement.
- Content and scope of intangible assets or services covered by the CSA, the specific participants performing research and development activities or service activities under the agreement, and their respective responsibilities and tasks.
- Terms of the agreement.
- Calculation methods and assumptions relating to the anticipated benefits to the participants.
- The amount, forms of payment, and valuation method of initial and subsequent cost contribution by the participants, and explanation of conformity with the arm's-length principle.
- Description of accounting methods adopted by participants and any changes.
- Requirements on the procedure and treatment for participants entering into, or withdrawing from, the agreement.
- Requirements on the conditions and treatment of compensating payments among participants.
- Requirements on the conditions and treatment of amendments to, or termination of, the agreement.
- Requirements on the use of the results of the agreement by non-participants.

Circular 2 states that the costs borne by the participants in a CSA should be consistent with those borne by an independent company for obtaining the anticipated benefits under comparable circumstances; furthermore, the anticipated benefits should be reasonable, quantifiable, and based on reasonable commercial assumptions and common business practices. Failure to comply with the benefit test will result in an adjustment by tax authorities in the event of an audit assessment.

Some other relevant provisions of Circular 2 with respect to CSAs include the following:

- Service-related CSAs generally should be limited to group procurement or group marketing strategies.
- Buy-in and buyout payments are required when there is a change to the participants of an existing CSA.
- During the term of a CSA, if there is a mismatch between the shared costs and the actual benefits, then compensating adjustments should be made, based on actual circumstances, to ensure the shared costs match the actual benefits.
- If a CSA is not considered arm's length or does not have a reasonable commercial purpose or economic substance, costs allocated under the agreement (as well as any appropriate compensating adjustments) will not be deductible for CIT purposes.
- Taxpayers may apply for an APA to cover a CSA.
- Participants to intangible development-related CSAs should not pay royalties for intangible properties developed under the CSA.
- The costs allocated under a CSA and deducted for CIT purposes by the taxpayer would need to be clawed back if its terms of operation turn out to be less than 20 years from the signing of the CSA.
- In addition to the contemporaneous TP documentation requirements under Chapter 3, Circular 2 also includes specific requirements for preparation of contemporaneous documentation for CSAs, which needs to be submitted to the tax authorities by 20 June of the following year.

Controlled foreign corporations (CFCs)

Article 45 of the CIT law provides for the inclusion in a Chinese taxpayer's taxable income the relevant profits of its CFCs, established in countries with effective tax burdens that are substantially lower than China's.

Circular 2 provides guidance for calculating the amount of the deemed income and any associated tax credits. Pursuant to Circular 2, the deemed dividend income from a CFC attributed to its Chinese resident enterprise shareholder should be determined using the following formula:

$$\text{Income attributed to a Chinese resident enterprise shareholder in the current period} = \text{Amount of deemed dividend distribution} \times \frac{\text{Number of shareholding days}}{\text{Number of days in the CFC's tax year}} \times \text{Shareholding percentage}$$

Circular 2 allows for the exemption from recognition as Chinese taxable income, any deemed dividend from a CFC that meets at least one of the following criteria:

- Is established in a country with an effective tax rate that is not considered low, as designated by the SAT.
- Has income derived mainly from active business operations.
- Has annual profit of less than RMB 5 million.

Thin capitalisation

The thin capitalisation rules under the CIT law are designed to disallow the deduction of excessive related-party interest expense pertaining to the portion of related-party debt that exceeds a certain prescribed debt-to-equity (D/E) ratio.

Circular Cai Shui [2008] No. 121 (Circular 121), jointly published by the Ministry of Finance and the SAT in October 2008, sets out the prescribed D/E ratios (2:1 for non-financial enterprises and 5:1 for enterprises in the financial industry) and other associated rules. However, Circular 121 also emphasises that 'excessive interest' from related-party financing which exceeds the prescribed ratios may still be deductible if an enterprise can provide documentation to support that the inter-company financing arrangements comply with the arm's-length principle, or if the effective tax burden of the Chinese borrowing company is not higher than that of the Chinese lending company.

Where the D/E ratio exceeds the prescribed ratio, the portion of related-party interest expense, relating to the excess portion, will generally not be deductible. Furthermore, the non-deductible outbound interest expense paid to overseas related parties would be deemed as a dividend distribution and subject to withholding tax (WHT) at the higher of the WHT rate on interest and the WHT rate on dividends.

Chapter 9 of Circular 2 provides specific thin capitalisation administrative guidance, which includes the following:

- Mechanics for how to calculate the D/E ratio (on a monthly weighted average basis).
- Related-party interest that is not arm's length will be subject to a TP investigation and adjustment before being evaluated for thin capitalisation purposes.

Preparation of contemporaneous thin capitalisation documentation is required in order to deduct excessive interest expense. Circular 2 stipulates that such documentation should include the following in order to demonstrate that all material aspects of the related-party financing arrangements conform to the arm's-length principle:

- Analysis of the taxpayer's repayment capacity and borrowing capacity.
- Analysis of the group's borrowing capacity and financing structure.
- Description of changes to equity investment of the taxpayer, such as changes in the registered capital, etc.
- Nature and objectives of debt investment from related parties, and the market conditions at the time the debt investment was obtained.
- Currency, amount, interest rate, term and financing terms of the debt investment from related parties.
- Collaterals provided by the enterprise and the relevant terms.
- Details of the guarantor and the terms of guarantee.
- Interest rate and financing terms of similar loans contemporaneous to the debt investment from related parties.
- Terms of conversion of convertible bonds.
- Other information that can support the conformity with the arm's-length principle.

The SAT Public Notice No. 34, issued on 9 June 2011 with effect from 1 July 2011, provides that, in order to obtain deductibility of interest expenses incurred in related-party loans, enterprises are required to document that interest payments for loans to

non-financial borrowers are 'reasonable' including standard interest rates for similar loans by financial institutions within the same province. The notice also addresses several other issues including the implications of an investing enterprise's reduction or withdrawal of its investment.

General anti-avoidance rules (GAAR)
By including GAAR, the CIT law formally authorises Chinese tax authorities to make an adjustment if a taxpayer enters into an arrangement 'without reasonable commercial purpose'. Furthermore, the inclusion of GAAR is a strong indication of the Chinese tax authorities' growing scrutiny of business structures.

Pursuant to Circular 2, a general anti-avoidance investigation should focus on the following transactions/structures:

- Abuse of preferential tax treatments.
- Abuse of tax treaties.
- Abuse of organisational structures.
- Use of tax havens for tax avoidance purposes.
- Other arrangements without reasonable commercial purposes.

Circular 2 places a special focus on the principle of substance over form and also provides details about the various procedures for conducting a 'general anti-avoidance investigation' and making a 'general anti-avoidance adjustment' including the requirement that all general anti-avoidance investigations and adjustments be submitted to the SAT for final approval. In addition, Circular 2 provides that the Chinese tax authorities will disregard entities that lack adequate business substance (especially those in tax haven countries).

On 2 December 2014, the SAT released the administrative rule on general anti-avoidance, namely 'Administrative Measures on the General Anti-Avoidance Rule (Trial)', in the form of SAT Order No. 32, which is a unique index evidencing the importance of the circular. The order takes effect from 1 February 2015. It also applies to cases which have not been assessed and closed before the prescribed effective date.

The SAT Order No. 32 explicitly provides the exclusion to the two scenarios as follows:

- Arrangements not involving cross-border transactions or payments.
- Failure to make tax payments, cheating of tax refunds, forged tax invoices and other tax-related violations.

The SAT Order No. 32 contains comprehensive guidance on the implementation of GAAR, including elaboration on certain principles, adjustment methods, procedures throughout the GAAR life cycle and relevant documentation requirements. It elaborates on some important principles for GAAR assessment, including:

- A tax avoidance scheme that is intended to obtain a tax benefit and without a reasonable commercial purpose is subject to GAAR adjustment.
- The characteristics of a 'tax avoidance scheme' are: 1) the sole or main purpose of the tax arrangement is to obtain a tax benefit; 2) the tax benefit is obtained by using an arrangement whose form is permitted in accordance with the tax rules, but is not consistent with its economic substance.

- Tax authorities should assess GAAR cases based on both 'purpose test' and 'substance test'.
- GAAR should be the last resort, i.e. GAAR shall not be invoked until the specific anti-avoidance rules (SAAR) (e.g. TP and thin-cap) and tax treaty provisions (e.g. beneficial owner) are exhausted.

The SAT Order No. 32 provides the tax authorities are empowered to make special tax adjustments by reference to other similar arrangements with reasonable commercial purpose and economic substance as the benchmark. The adjustment methods include:

- Re-characterise entire or part of the arrangement.
- Disregard the existence of a transaction party for taxation purposes or deem this transaction party and the other transaction party as the same entity.
- Re-characterise the relevant income, deduction, tax incentives, foreign tax credits, etc. or reallocate the split among the transaction parties.
- Any other reasonable method.

The order provides a set of comprehensive procedures for the GAAR implementation by the tax authorities at different level, namely:

- Selection of potential cases.
- Investigation process.
- Determination.
- Dispute resolutions.

In each stage, the order set forth clear roles and responsibilities for different levels of tax authorities. For instance, the relevant in-charge tax authorities may initiate GAAR investigation on an arrangement only upon approval by the SAT. The final determination on whether GAAR should be invoked also rests with the SAT.

The onus of proof under a GAAR investigation rests with the taxpayer under scrutiny, who shall provide extensive documentation and evidence within 60 days upon request (with a possible extension of 30 days) to prove that the arrangement in question is not a tax avoidance scheme. Other parties, including related parties and the 'planners' of the tax avoidance scheme are also obligated to provide information upon request.

China special features

Multiple audits

In general, China does not allow consolidation of CIT returns for multinational companies (MNCs). An MNC with subsidiaries located in various parts of China may, therefore, be subject to multiple TP audits or in some cases, the so-called national TP audit orchestrated by the SAT.

Management fees

Under Article 49 of the DIR, management fees paid to related parties are not deductible for CIT purposes. On the other hand, service fees are deductible. According to Article 8 of the CIT law, a taxpayer may deduct reasonable expenses (including service fees paid to its related parties) that are actually incurred and are related to the generation of income. As there is no clear guidance on how to distinguish between service fees and management fees, tax authorities in different locations may have different views and practices in this regard.

Turnover taxes
In establishing TP policies for China, it is important for foreign investors to realise that income tax is not the only tax issue. Besides Chinese CIT, other taxes such as business tax, value-added tax, consumption tax and customs duties can be quite significant. Therefore, TP arrangements involving China-related parties must also consider the implications of other taxes.

Areas of focus in China
The SAT has publicly mentioned the following areas in which they are currently focusing their attention:

- *Location savings:* The SAT officials have raised the point in competent authority (CA) discussions that more profits should be attributed to China due to the efficiencies and lower cost of its labour force, and more broadly, advantages specific to China including those resulting from Government policies.
- *China country premium:* The fact that China is one of the largest, fastest-growing markets is also being used as a basis by the SAT officials to argue for a profit premium for companies catering to the China market. For example, many multinationals in the automobile industry now generate a majority of their profits in China. The SAT officials believe that this unique country premium should be taxed in China and are discussing approaches to reasonably quantify such premium.
- *Intangibles:* Following the BEPS initiatives, the SAT requests that the contribution of each related party to the value creation of the intangible assets should be considered to determine the economic benefits that each party is entitled to.
- *Outbound payments:* According to the SAT Public Notice [2015] No. 16 (Pubic Notice Regarding certain Corporate Income Tax Matters on Outbound Payments to Overseas Related Parties) issued on 18 March 2015 (with immediate effect on the issuance date), outbound payments to overseas related parties should satisfy the arm's-length principle and the authenticity test. It specifies various circumstances where payments, service fees or royalties paid to overseas related parties would not be deductible for corporate income tax (CIT) purposes.
- *Review:* A national group of elite TP specialists is being formed to review and approve all TP audit cases in China. The group will be formed from the most experienced TP auditors from around China at all levels including city, county, provincial and national. The SAT is also considering bringing in additional economists or analysts to handle high-profile/important cases such as those in the automotive industry, which currently may be considered the most high-profile industry in China.

Penalties

Special interest levy

Under the CIT law, special tax adjustments (including TP adjustments) are subject to a special interest levy. The special interest levy mechanism is different from surcharges and fines, which constitute the normal penalty measures levied during routine tax collection and administration.

Article 122 of the DIR defines the rate for the special interest levy as based on the RMB loan base rate applicable to the relevant period of tax delinquency as published by the People's Bank of China in the tax year to which the tax payment relates, plus 5 percentage points. This interest levy is not deductible for CIT purposes.

Although companies with annual related-party transactions below the materiality thresholds for contemporaneous documentation are not subject to the 5% penalty component of the interest levy, such protection does not apply in situations where the amount of related-party transactions originally falls below the thresholds, but the restated amount of related-party transactions as a result of a TP adjustment exceeds the relevant threshold. Circular 2 further provides that the 5% penalty component of the interest levy may be waived if the taxpayer has prepared and provided contemporaneous documentation in a timely manner.

Fines

Taxpayers that fail to file the annual related-party transactions disclosure forms to tax authorities or fail to maintain contemporaneous documentation and other relevant information in accordance with Circular 2 shall be subject to different levels of fines, ranging from less than RMB 2,000 up to RMB 50,000, in accordance with Articles 60 and 62 of the Tax Collection and Administration Law.

Taxpayers that do not provide contemporaneous documentation or relevant information on related-party transactions or provide false or incomplete information that does not truly reflect the situation of their related-party transactions shall be subject to different levels of fines, ranging from less than RMB 10,000 up to RMB 50,000, in accordance with Article 70 of the Tax Collection and Administration Law and Article 96 of the Tax Collection Regulations. In addition, tax authorities also have the authority to deem such taxpayers' taxable income by reference to the profit level of comparable companies, the taxpayer's cost-plus reasonable expenses and profit, or apportioning a reasonable share of the group's total profits. Alternatively, a deemed profit may be determined, based on other reasonable methods according to Article 44 of the CIT law and Article 115 of the DIR.

Surcharge

In the context of TP adjustments, taxpayers that have exceptional difficulty and cannot remit the tax payment on time shall apply for an extension in accordance with Article 31 of the Tax Collection Law and Articles 41 and 42 of the Tax Collection Regulations. A daily surcharge of 0.05% will be levied in accordance with Article 32 of the Tax Collection Law if they do not apply for an extension and fail to remit the underpaid taxes and interest levies before the deadline set by the tax authorities on the adjustment notice.

Documentation

Information reporting

Annual tax return disclosure of related-party transactions

China's annual related-party transaction disclosure forms (required under Article 11 of Circular 2) were officially introduced by the SAT in December 2008 under *Guo Shui Han* [2008] No. 114 (Circular 114). Circular 114, which took effect on 1 January 2008, lists the following nine TP-related forms that Chinese taxpayers must file as part of their new CIT returns:

- Form 1: Related Party Relationships Form.
- Form 2: Summary of Related Party Transactions Form.
- Form 3: Purchases and Sales Form.
- Form 4: Services Form.
- Form 5: Financing Form.

- Form 6: Transfer of Intangible Assets Form.
- Form 7: Transfer of Fixed Assets Form.
- Form 8: Foreign Investment Status Form (This form was replaced on 1 September 2014).
- Form 9: Foreign Payments Status Form.

These forms, which generally need to be filed along with the Chinese CIT returns, require taxpayers to indicate whether they have contemporaneous documentation in place to substantiate their inter-company arrangements and to provide detailed information on each type of related-party transactions (including specifying the applicable TP method).

On 30 June 2014, SAT released the SAT Public Notice [2014] No. 38 (Public Notice Issued by the SAT Regarding Information Disclosure by Tax Resident Enterprises [TRE] on Outbound Investment and Overseas Income) setting forth the administrative guidelines for the Chinese TREs to report the information of their outbound investment and overseas income, covering the scenarios required to report, documentation requirements, etc. It further stipulates that where the CFC rule applies, the TRE shall file the form of CFC Information together with annual CIT filing package. Form 8 was replaced when the SAT Public Notice [2014] No. 38 came into effect on 1 September 2014.

In addition, a 'special tax adjustment' option in the annual CIT return package practically allows taxpayers to make voluntary upward adjustments to their taxable income.

While the statutory filing deadline for CIT returns is 31 May, some local-level tax authorities may impose an earlier filing due date. Therefore, it is essential for taxpayers to closely monitor and follow the local requirements specified by the local-level tax authorities.

Contemporaneous transfer pricing documentation
Under Circular 2, Chinese taxpayers generally are required to have contemporaneous TP documentation in place unless they meet any of the following criteria:

- The annual amount of related-party purchases and sales transactions is less than RMB 200 million and the annual amount for all other types of transactions (i.e. services, royalties, interest) is less than RMB 40 million.
- The related-party transactions are covered by an APA.
- The foreign shareholding of the enterprise is below 50%, and the enterprise has only domestic-related-party transactions.

The contemporaneous TP documentation requirement was expanded by a subsequent circular to include certain loss-making companies with limited functions or risks, as discussed later in this section.

According to Article 14 of Circular 2, the contemporaneous TP documentation package should contain 26 specific items grouped under the following five areas:

- Organisational structure (four items).
- Description of business operations (five items).
- Description of related-party transactions (seven items).
- Comparability analysis (five items).
- Selection and application of TP method (five items).

(Additional items are required for contemporaneous cost-sharing and/or thin capitalisation documentation.)

According to Circular 2, Chinese contemporaneous documentation must be:

- Prepared and maintained for each tax year.
- Completed by 31 May of the following year (e.g. 31 May 2014 for 2013 tax year) and kept for 10 years (e.g. until 31 May 2024 for 2013 tax year).
- Provided within 20 days of a request (or within 20 days of elimination of any *force majeure*).
- In Chinese (including any source materials provided in English as part of the documentation).

As with the annual filing, some local-level tax authorities may impose due dates or submission timelines other than those listed above, and taxpayers should be prepared to submit documentation earlier if required by the in-charge tax authorities.

Tax underpayments that result from special tax adjustments (including TP adjustments) are subject to an interest levy that includes a 5% penalty component. That penalty component can be avoided if the taxpayer prepares and submits contemporaneous documentation in a timely manner upon request, or if the taxpayer is otherwise exempted from the documentation requirement. The interest levy is discussed in more detail later.

Documentation requirement for loss-making companies with limited functions/ risks

According to Article 39 of Circular 2, companies engaged in simple manufacturing activities based on orders from related parties must earn a stable rate of return and should not be expected to bear the risks or suffer the losses associated with excess capacity, product obsolescence and other such factors. In July 2009, the SAT issued Guo Shui Han [2009] No. 363 (Circular 363). Circular 363 re-emphasises the SAT's position towards losses incurred by companies with limited functions and risks, and even goes one step further than Circular 2 by requiring all loss companies with limited functions and risks to prepare and submit contemporaneous documentation to their in-charge tax authorities by 20 June following the loss-making year – regardless of whether the amount of related-party transactions exceeds the materiality thresholds. It is worth noting that, through Circular 363, the SAT has expanded the focus of scrutiny to trading companies and contract R&D (research and development) service providers in addition to simple manufacturers.

Collection and review of contemporaneous transfer pricing documentation

On 12 July 2010, the SAT issued Circular Guo Shui Han [2010] No. 323 – Notice of the SAT Regarding the Sample Review of Contemporaneous Transfer Pricing Documentation (Circular 323), mandating local-level tax authorities to carry out a nationwide evaluation of taxpayers' 2008 and 2009 contemporaneous TP documentation. Circular 323 specifies that the local-level tax authorities must select for collection and review the documentation of at least 10% of taxpayers, which are subject to the documentation requirements for each year. Various tax authorities have provided feedback based on this review including common problem areas seen in documentation reports. This review process has continued in the following years (i.e. 2011 and 2012) and tax authorities have been observed to be generally more active in collecting contemporaneous TP documentation from taxpayers.

Tax authorities in certain locations have shown distinct interest in collecting contemporaneous documentation. A number of local-level tax authorities have taken either a 'blanket' approach (whereby all taxpayers exceeding the thresholds have been required to submit documentation) or a 'targeted' approach (e.g. focusing on large MNCs with significant related-party transactions, or creating a list of potential audit targets and requesting them to provide documentation) with respect to the collection of documentation. The documentation collection efforts are thought to have multiple objectives including the creation of an internal database, identification of potential audit targets and proactive tax compliance enforcement.

Transfer pricing controversy and dispute resolution

Burden of proof

In China, the burden of proof that a related-party transaction was conducted at arm's length rests with the taxpayer. According to Paragraph 2 of Article 43 of the CIT law, if the tax authorities conduct a TP investigation, the taxpayer under investigation, its related parties and other relevant companies are obligated to provide 'relevant information' upon request. If the taxpayer under investigation fails to provide information in relation to its related-party transactions or provides false or incomplete information that does not truly reflect the situation of its related-party transactions, the tax authorities are authorised to determine what the appropriate level of taxable income should be (i.e. deemed taxable income).

According to the DIR, information required by the tax authorities during a TP investigation may include the following:

- The taxpayer's contemporaneous TP documentation.
- Relevant overseas' information regarding resale price (or transfer price) and/or ultimate sales' price of tangible goods, intangible goods and services involved in the related-party transactions.
- Other relevant information relating to related-party transactions.

Audit targets

Circular 2 provides insight into the procedural aspects of a Chinese TP audit, from the tax authorities determining which enterprises will be subject to audit and conducting the audit to issuing a 'special tax adjustment notice', collecting underpaid taxes (and interest) and a five-year post-audit follow-up period. These provisions are generally in line with China's previous TP rules and consistent with the way the prior rules were enforced in practice.

According to Circular 2, TP audits typically will focus on companies with the following characteristics:

- Significant amount or numerous types of related-party transactions.
- Long-term consecutive losses, low profitability, or fluctuating pattern of profits/losses.
- Profitability lower than those in the same industry, or with profitability that does not match their functions/risks.
- Business dealings with related parties in a tax haven.
- Lack of contemporaneous documentation or TP-related tax return disclosures.
- Other situations clearly indicating a violation of the arm's-length principle.

Circular 2 also provides that, in principle, no TP audits will be carried out on, and no TP adjustment will be made to, transactions between domestic-related parties that had the same effective tax burden, as long as such transactions did not result in the reduction of the country's total tax revenue.

It is also worth noting that the SAT has been continuing to strengthen its focus on nationwide and industry-wide TP audits. In a nationwide audit, companies within a multinational group are simultaneously audited, whereas industry-wide audits focus on companies in specific industries. According to the statistics released by the SAT, in 2014 a total of 257 TP audit cases have been concluded with the average tax adjustment per case of RMB 30.68 million. (This represents an increase of 17% compared to the historic high in 2012 (RMB 26.20 million of tax adjustment per case). Among them, 20 cases were concluded with an adjustment of over RMB 100 million. We understand that the relatively large adjustments of these cases may be the result of increased enforcement activities taken by the tax authorities at different levels across China, especially on cross-border issues. In the face of BEPS initiatives, it is not surprising to see that the Chinese tax authorities are continuing to combat tax avoidance through TP enforcement.

Audit information request

According to the CIT law, its DIR and Circular 2, not only the taxpayer under a TP investigation, but also its related parties and other relevant companies (i.e. potential comparable companies) are obligated to provide information as requested by the in-charge tax authorities.

As previously mentioned, the taxpayer under an investigation should provide contemporaneous documentation to tax authorities within 20 days of a request and, according to the 'Notice of Tax Related Issues', should provide other relevant documents requested during an investigation within the prescribed timeframe. If timely submission of required documents is not possible due to special circumstances, the taxpayer under investigation shall apply in writing for an extension. An extension of up to 30 days may be granted, subject to the approval from the in-charge tax authority. Related parties of the taxpayer under investigation or comparable companies shall provide relevant information within the timeframe as agreed with the tax authorities (which generally will not be longer than 60 days).

If the taxpayer under audit fails to provide information within the prescribed timeframe as required by the tax authority or refuses to provide information as requested, it may be subject to one or more of the following:

- An administrative penalty of up to RMB 10,000 in accordance with the Tax Collection and Administration Law.
- A special tax adjustment as determined by the tax authority by means of deeming the taxpayer's taxable income.
- An additional 5% interest levy on the amount of underpaid tax resulting from the adjustment.

The audit procedure

Special tax investigation procedures

Tax audits in China may be conducted at the taxpayers' offices or at tax authorities' offices. A TP audit (or a special tax investigation) procedure typically comprises the following main steps:

- Desktop review and selection of TP audit targets by the tax authority.
- Notification to the taxpayer of a TP audit and field investigation by the tax authority to raise inquiries, request accounting records and conduct onsite verification.
- Information request to taxpayer under investigation, its related parties, or other relevant companies for relevant documents.
- Negotiation and discussion with the taxpayer under investigation and the tax authority.
- Initial assessment notice issued by the tax authority.
- Further negotiation and discussion between the taxpayer and the tax authority, as needed.
- Final assessment and issuance of 'Special Tax Adjustment Notice' if there is an adjustment, or 'Special Tax Investigation Conclusion Notice' if the related-party transactions under investigation are considered to be at arm's length.
- Settlement of underpaid taxes and interest levy.
- Post-audit follow-up management by the tax authority.

In addition, Article 123 of the DIR provides that adjustments may be made on a retroactive basis for up to ten years as a result of a special tax investigation.

Internal working guidelines for special tax adjustment cases

To address the working guidelines for tax officials in special tax adjustment cases, the SAT issued *Guo Shui Han* [2012] No. 13 (Circular 13) <Internal Working Guidelines for Special Tax Adjustments (Trial)> and *Guo Shui Han* [2012] No. 16 (Circular 16) <Working Guidelines on Joint Review for Major Special Tax Adjustments Cases (Trial)>, both of which took effect on 1 March 2012.

Circular 13 sets out the roles, responsibilities and internal working guidelines for the different tax authorities across China working on such cases. Further, it provides guidance on centralising management on special tax adjustments and developing an information database to identify suspicious TP violations.

In Circular 16, the SAT introduced a joint panel review mechanism for Major Special Tax Adjustment (MSTA) cases in order to standardise the administration of such cases. According to Circular 16, MSTA cases include the following:

- Cases involving a taxpayer with registered capital over RMB 100 million and average annual revenues from main operation over RMB 1 billion during the investigation period.
- Nationwide industry joint audit or group audit cases.
- Other cases so designated by the SAT.

Joint investigations
China generally will not join another country in undertaking a joint investigation of a multinational group for TP purposes. However, some Chinese tax treaties contain an Exchange of Information article that provides for the cooperation between the competent authorities in the form of exchanges of information necessary for carrying out the provisions of the treaty (including TP investigations). In practice, the methods of exchanging information include exchange on request, spontaneous exchanges and automatic exchanges.

In recent years, the Chinese tax authorities have also been exploring other forms of international cooperation including joining the Joint International Tax Shelter Information Centre (JITSIC) as a member in 2010.

There are intra-country TP investigation cases in which authorities in different locations coordinate their efforts in conducting simultaneous audits on Chinese subsidiaries of a group corporation.

Post-audit follow-up administration
On 16 April 2009, the SAT issued tax Circular Guo Shui Han [2009] No. 188 (Circular 188), to further strengthen its TP follow-up administration. The circular reiterates the requirement found in Article 45 of Circular 2 that tax authorities are to follow up for five years after any adjustment, during which period, post-adjustment enterprises must submit contemporaneous TP documentation by 20 June of the following year. This documentation is used by the Chinese tax authorities to closely monitor the related-party transactions of the enterprises under TP follow-up administration. Decreases in operating profits or sustained losses will be closely scrutinised and possibly disallowed by the Chinese tax authorities if the underlying nature of the related-party transactions remains unchanged. If an APA is initiated, monitoring shall be continued until the APA is signed. This longer post-audit supervision period (previously three years) indicates that TP compliance violations are being taken more seriously.

Assessments and appeal procedures
Transfer pricing audits in China are usually settled through negotiation. While the conduct of the taxpayer should not significantly affect the outcome, a friendly working relationship with the tax authorities is always to the taxpayer's advantage, as Chinese tax legislation gives broad discretionary powers to tax authorities.

When an enterprise under audit receives an initial assessment from the tax authority and disagrees with the assessment, it may provide written explanations and documents supporting the reasonableness of its transfer prices. Further discussions and negotiations may continue until the tax authority reaches a conclusion and issues a written notice of audit assessment in the form of a 'Special Tax Adjustment Notice', or

a 'Special Tax Investigation Conclusion Notice'. Once the written notice is issued, the decision is considered final and further negotiation is not possible.

If the taxpayer disagrees with the adjustment, such dispute could be resolved through the appeal procedures. China's Tax Collection and Administration Law provide both administrative and judicial appeal procedures for resolving tax disputes. The taxpayer may appeal to the tax authority at the next higher level, within 60 days, for an administrative appeal, and a decision on the appeal must be made within 60 days. Before proceeding with the appeal process, the taxpayer is required to pay the taxes, interest levy, and fine and surcharge (if any).

If the taxpayer is not satisfied with this decision, it may start legal proceedings in China's People's Court within 15 days upon receiving the written decision. There have been very few cases relating to TP brought before the People's Court at the local level. The local court has generally found in favour of the SAT. Because there is limited experience in court cases and the SAT has expansive discretionary powers, taxpayers generally should seek a mutually satisfactory resolution before the issuance of the adjustment notice.

For related-party transactions between China and a treaty country, mutual consultation between the SAT and the competent authority (CA) of the treaty country is available to taxpayers to resolve double taxation issues resulting from TP adjustments.

Corresponding adjustments

Circular 2 provides that corresponding adjustments should be allowed in the case of a TP adjustment to avoid double taxation in China. If the corresponding adjustment involves an overseas related-party resident in a country with which China has a tax treaty, then the SAT will – upon application by the taxpayer – initiate negotiations with the CA of the other country, based on the MAP article of the treaty. (The statute of limitation for the application of corresponding adjustments is three years; an application submitted after three years will not be accepted or processed.) Application for the initiation of the MAPs should be submitted to both the SAT and the local tax authorities simultaneously.

Where payment of interest, rent, or royalties to overseas related parties was disallowed as the result of a TP adjustment, no refund of the excessive WHT payment will be made. This treatment may result in double or even triple taxation for MNCs in some cases.

If the original adjustment is imposed by the overseas' tax authority, then the Chinese enterprise could submit a formal application for a corresponding adjustment to the relevant Chinese tax authority within three years of the overseas related-party's receipt of the notice of the TP adjustment.

Circular 2 indicates that corresponding adjustments are not available in cases of income taxes assessed on deemed dividends that result from non-deductible interest expenses under the thin capitalisation rules.

Circular 2 also states that the results of a corresponding adjustment or mutual agreement will be sent to the enterprise in written form from the SAT, via the in-charge tax authority.

Resources available to the tax authorities

China's tax authorities are organised in a multilayer structure, with the SAT being the central office at the top, guiding provincial, municipal, and county or district level offices across the country. A dedicated group of officers are assigned at both the central and local levels to handle matters including TP and special tax adjustment cases. At the central level, the SAT's anti-avoidance resources have doubled and are now divided into two separate teams to monitor, develop and interpret TP regulations in China, focusing their attention to the different anti-avoidance issues and initiatives. These officials have frequent exchanges with tax authorities in other countries and with the OECD. Initiation and conclusion of a TP audit requires the approval of the central SAT officials, who will act in a supervisory and supporting role to local tax officials at various levels and locations, who will directly conduct audits. However, the simultaneous efforts of various tax officials can often lead to an increased burden on taxpayers. In cases involving MAPs or bilateral/multilateral APAs, the SAT takes the lead role in the competent authority discussions.

The SAT has been advocating a three-pronged approach of 'administration, services and investigation' in relation to TP administration. Administration focuses on taxpayers' compliance and preventing TP abuses; services focuses on APAs and MAPs, as these are considered services by the tax authorities to taxpayers; investigation focuses on formal TP audits. For the SAT, this is a significant, philosophical change in tax administration, as historically the focus has always been on tax administration and investigation. While providing services to taxpayers has been focused on, only recently, the emphasis is certainly a welcome sign to taxpayers.

Guo Shui Han [2012] No. 41 (Circular 41) reiterates the importance of developing an anti-tax avoidance system, which integrates administration, service and investigation. This is consistent with SAT's prior anti-avoidance circulars, especially Guo Shui Han [2011] No.167. Circular 41 also provides a comprehensive roadmap on China's international taxation policies for the 12th five-year period (i.e. years from 2011 to 2015).

Comparison with OECD Guidelines

While China has observer status with the OECD, it has for the most part modelled its TP legislation after the OECD Guidelines. In general, China's TP regulations reflect the same arm's-length principle and support the same type of TP methodologies that are being adopted in the OECD member countries. However, a TP policy or practice that is acceptable in an OECD member country will not necessarily be followed in China (e.g. collaboration between the customs and tax authorities in determining the transfer price/import value of related-party tangible goods transactions).

On 2 October 2012, the UN released ten chapters of its Practical Manual on Transfer Pricing for Developing Countries (UN TP Manual), in which China contributed a paper on its country practices for Chapter 10. The paper discusses the SAT's views on a number of TP matters including reliability of comparables, location-specific advantages, practical issues and solutions, alternative methods to TNMM and other experience and recommendations. Afterwards, the UN Committee of Experts on International Cooperation in Tax Matters formed a subcommittee on Article 9 of the UN Model Taxation Convention (the Article on 'Associated Enterprises') to draft an additional chapter on intragroup services and management fees as well as intangibles. The subcommittee invited feedback from the public, in particular developing countries.

China

In response to the UN's request for comments, China's SAT submitted a written response to express its views and provided recommendations. In its letter the SAT reaffirms its stance that service fees paid and received by related parties must be in compliance with the arm's-length principle. Regarding management fees, the SAT states that these expenses, in general, relate to shareholder activities and therefore are not deductible for China income-tax purposes.

The SAT also shared some practical difficulties in conducting TP investigation in relation to service transactions while making recommendations for the next update of the UN TP Manual:

- Validating the authenticity of the services rendered and the reasonableness of the associated allocation mechanisms: The SAT recommends that the UN TP Manual refer to the TP documentation requirements proposed in the OECD's Action Plan on BEPS.
- Differentiation between royalties and technical service fees: The SAT recommends that the UN TP Manual provide additional guidance on how to differentiate royalties from technical service fees.
- Definition of shareholder activities: The SAT generally follows the OECD TP Guidelines regarding services but considers the definition of shareholder activities under the OECD standards to be too narrow.

24.

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Overview

Act 1607 of 2012, included several modifications to the Colombian tax code, including transfer pricing (TP), which were enacted by Regulatory Decree 3030 of 2013. Transfer pricing regulations have a greater emphasis on intragroup services, financial transactions, permanent establishments (PEs), shared cost agreements, business restructurings, as well as a new penalty regime, and the criteria to define related parties, among others.

Country	**Colombia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Only for transactions with free trade zones
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	On a yearly basis with a study and return filing
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes

Colombia

Country	Colombia
How are penalties calculated?	Formal TP penalties are calculated in taxable units and income tax penalties, per a TP adjustment, are calculated as a percentage of the additional tax.

Introduction

Colombia first introduced TP regulations through Act 788 in 2002, followed by Act 863 in 2003 which specified and clarified the scope. Later, Act 1607 in 2012 introduced important changes that are applicable as of fiscal year 2013. Subsequently, the Regulatory Decree 4349 of 2004 enacted the enforcement of the formal and substantial TP obligations, which was recently replaced by Regulatory Decree 3030 of 2013.

Colombian regulations regarding TP apply from fiscal year 2004 (in Colombia calendar year equals fiscal year for all companies), are consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines, and are part of a government effort to prevent income tax avoidance. The TP rules address specific issues such as financial transactions, application of the arm's-length range, and adjustment to the median when the taxpayer's margins or prices fall out of the arm's-length range, and considerations of the industry and/or life business cycles.

Colombian tax authorities (*Dirección de Impuestos y Aduanas Nacionales*, or DIAN) are entitled to assess taxpayers' transactions, subject to the rules as of year 2005.

Legislation and guidance

Statutory rules

Transfer pricing rules apply to taxpayers engaging in transactions with related parties located abroad, and in free trade zones (FTZs) and with entities in tax havens. These rules impact the income tax and the Corporate Contribution for Equality (CREE for its acronym in Spanish) computation regarding ordinary and extraordinary income, expenses (costs and deductions), and the determination of assets and liabilities between related parties. Therefore, the rules do not affect the determination of other taxes under such transactions, such as industry and trade tax, value-added tax and customs.

All transactions with related parties are subject to the rules, including transfer or use of tangible and intangible property, provision of services and financial transactions such as loans and investments.

Regarding the application of any of the TP methods, the rules clarify that income, costs, gross profit, net sales, expenses, operating profits, assets, and liabilities should be determined based on Colombian generally accepted accounting principles (GAAP).

Related party
The concept of related party is defined in Sections 260-1 and 260-2 of the Colombian Tax Code which includes situations ranging from statutory to economic dependency and control of companies by individuals, as follows:

- Subordinates
  a. An entity will be a subordinate or controlled when its decision making power is subject to the will of another person, or persons, or entities that shall be its parent company or controlling entity, either directly (in which case the company will be considered an affiliate) or jointly with or through other subsidiaries of the parent (in which case the company would be considered a subsidiary).
  b. A company shall be a subordinate whenever it falls under one or more of the following cases:
     1. When more than 50% of its equity belongs to the parent, directly or jointly with or through its subsidiaries, or the latter's subsidiaries. For these purposes, non-voting preferred shares of stock shall not be taken into account.
     2. When the parent and the subsidiaries hold jointly or separately the right to cast the number of votes required to constitute the minimum decision making majority at the members or shareholders' meeting, or where they have the number of votes required to appoint the majority of the directors of the company, should there be a board of directors.
     3. When the parent, directly or jointly with or through its subsidiaries, by virtue of an act or agreement with the controlled company or its shareholders, exerts dominant influence in the making of decisions of the management organs of the company.
     4. Likely, subordination exists when control – according to the assumptions established in this Section – is exercised by one or several individuals or legal persons or non-corporate schemes, directly or jointly or through entities in which they own more than 50% of the equity or constitute the minimum majority for making decisions or exercise dominant influence in management or in the decisions of the entity.
     5. Likewise, subordination exists when a person or the same persons or legal entities, or a same non-corporate vehicle(s), jointly or separately, have the right to receive 50% of the subordinate's profits.
- Branches with respect to its head offices.
- Agencies with respect to the societies to which they belong.
- Permanent establishments with respect to the company whose activity they perform totally or partially.
- Other cases of economic linking or related-party configuration:
  a. When the transaction is carried out between two subordinates of the same parent company.
  b. When the transaction takes place between two subordinates that belong directly or indirectly to the same individual, or legal entity, or entities, or schemes of non-corporate nature.
  c. When the transaction is carried out between two companies in which the same individual or legal entity participates directly or indirectly in the administration, control, or equity of both companies. Said participation may happen when i) it holds, either directly or indirectly, more than 50% of the capital of the company, or ii) it has the decision making power over the business.

d. When the transaction takes place between two companies in which more than 50% of their capital (directly or indirectly) belongs to persons who are married or who are relatives up to the second degree of consanguinity or affinity, or first degree of adoption-based kinship.
e. When the taxable transaction is carried out between related parties through non-related parties.
f. When more than 50% of the gross revenue is derived individually or jointly from shareholders, partners, or similar.
g. In the case of consortiums, temporary consortiums, joint ventures, other associative forms that do not give rise to new legal entities, and other forms of collaboration agreements.

There is economic linking between all societies and vehicles, or non-corporate entities that are part of a group, even if their parent company is located abroad.

When a foreign entity, related to a PE in Colombia, carries out a transaction with another foreign entity for the benefit of the said establishment, the latter will be required to determine, for income tax purposes, its ordinary and extraordinary revenues, costs and deductions, and assets and liabilities considering the arm's-length principle for those transactions.

Likewise, when income taxpayers carry out transactions with related parties located in Colombia, where a PE of one of them is abroad, they are required to determine, for income tax purposes, their ordinary and extraordinary revenues, costs and deductions, and assets and liabilities, considering the arm's-length principle for those transactions.

Regardless of what is established in other provisions of the Tax Code, income taxpayers located, domiciled, or resident in the national customs territory, which carry out transactions with related parties located in FTZs are required to determine, for income tax purposes, their ordinary and extraordinary revenues, costs and deductions, and assets and liabilities, considering the arm's-length price for those transactions.

Tax havens

Transactions carried out by income taxpayers with persons, societies, entities or companies located, resident or domiciled in tax havens are subject to the TP regime and must comply with the obligation of filing a TP supporting documentation and an informative return regardless that their gross equity or gross revenues are lower than the established caps.

The list of countries or jurisdictions considered as tax havens applicable for fiscal year 2014 was established by Regulatory Decree 2193 of 2013 as follows:

Jurisdictions considered as tax havens for fiscal year 2014		
• Andorra	• Guyana	• Pitcairn, Henderson, Ducie, and Oeno Islands
• Angola	• Hong Kong	• Qeshm Island
• Anguilla	• Isle of Man	• Saint Helena, Ascension and Tristan da Cunha
• Antigua and Barbuda	• Jordan	• Saint Kitts and Nevis Islands
• Bahamas	• Labuan	• Saint Lucia

Jurisdictions considered as tax havens for fiscal year 2014		
• Bahrain	• Lebanon	• Saint Pierre and Miquelon
• Bailiwick of Jersey	• Liberia	• Saint Vincent and the Grenadines
• British Virgin Islands	• Liechtenstein	• Salomon Islands
• Brunei Darussalam	• Macao	• Seychelles
• Cabo Verde	• Maldives	• Svalbard
• Cayman Islands	• Marshall Islands	• Trinidad and Tobago
• Commonwealth of Dominica	• Mauritius	• Vanuata
• Cook Islands	• Monaco	• Western Samoa
• Cyprus	• Nauru	• Yemen
• Grenada	• Oman	

With the enactment of Regulatory Decrees 1966 and 2095 of 2014, the applicable list was updated for fiscal year 2015.

Jurisdictions considered as tax havens for fiscal year 2015		
• Angola	• Labuan	• Saint Kitts and Nevis Islands
• Antigua and Barbuda	• Lebanon	• Saint Lucia
• Bahamas	• Liberia	• Saint Pierre and Miquelon
• Bahrain	• Macao	• Saint Vincent and the Grenadines
• Brunei Darussalam	• Maldives	• Seychelles
• Cabo Verde	• Marshall Islands	• Solomon Islands
• Commonwealth of Dominica	• Mauritius	• Svalbard
• Cook Islands	• Nauru	• Trinidad and Tobago
• Grenada	• Oman	• Vanuatu
• Guyana	• Pitcairn, Henderson, Ducie, and Oeno Islands	• Western Samoa
• Hong Kong	• Qatar	• Yemen
• Jordan	• Qeshm Island	
• Kuwait	• Saint Helena, Ascension and Tristan da Cunha	

Transfer pricing methods and best method rule

Following the spirit of the OECD Guidelines, the TP rules specify the methods for the TP analysis, as well as the comparability factors that should be taken into consideration when assessing controlled transactions in relation to those performed by independent third parties in comparable transactions. In Colombia, Section 260-3 of the Tax Code establishes the following five TP methods:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Transactional net margin method (TNMM).
- Profit split method (PSM).

Transfer pricing rules do not establish an order in the application of the aforementioned methods, nor the specific cases where they must be applied. In practice, taxpayers must consider the most appropriate method according to the following criteria: i) facts and circumstances based in a detailed functional analysis, ii) the availability of reliable information, iii) comparability degree, and iv) reliability of comparability adjustments.

Tested party

For the application of TP methods that require the selection of a tested party, the Colombian TP rules do not determine which party should be subject to analysis. Therefore, it is permissible to choose as the tested party either the local or the foreign-related party when conducting the TP analysis. When the foreign-related party is used as the tested party in the TP analysis, it will be necessary to include in the TP supporting documentation all the details of the functions, assets, and risks (functional, industry, and economic analysis) that will allow for assessing the reasonableness of the selection and application of the method.

Other regulations

Related rules

The following Tax Code provisions do not apply whenever taxpayers' transactions are analysed according to TP rules:

- Presumptive interests (Section 35).
- Determination of gross income in the sale of assets (Section 90).
- Other non-deductible payments (Section 124-1).
- Non deductibility of losses derived from the sale of assets to related parties (Section 151).
- Non deductibility of losses derived from the sale of assets from companies to shareholders (Section 152).
- Cases in which occasional losses are not accepted (Numbers 2 and 3 of Section 312).

It is also established that transactions to which TP rules apply will not be subject to the limitations on costs and deductions established in the Tax Code for transactions with related parties (Section 260-8).

Other considerations

With the enactment of Act 1607 of 2012, TP rules had important changes of which the following stand out:

- Purchase of used assets. The CUP method will be applied through the invoice issued by a third party when the new asset was acquired and the application of the depreciation according to Colombian GAAP. Only when the asset is sold in a different state, the original invoice is not available or is an asset built or assembled, is it possible to use a technical valuation by a third party not linked to the company in terms of work.
- Purchase and sale of shares. For transactions regarding shares that are not quoted in stock exchanges and transfers of other kind of assets that have comparability difficulties, generally accepted valuation methods must be used, particularly the one that calculates the market value throughout the present value of future revenues, and under no circumstance will the equity value or intrinsic value be accepted as a valid valuation method.

- Intragroup services or cost sharing agreements. The taxpayer must demonstrate the actual rendering of the service and that its value is according to the arm's-length principle.
- Business restructurings. They consist of the distribution of functions, assets, and risks carried out by national companies to their related parties abroad, for which the taxpayer must have retribution according to the arm's-length principle.
- Certified Information. Financial and accounting data used in the preparation of the supporting documentation must be certified by the statutory auditor. For this purpose and when segmented information is necessary, it must be prepared according to Colombian GAAP and the corresponding certification must be attached.
- Payments to tax havens. When making payments to tax havens it will be necessary to document and demonstrate the details of the functions, assets, and risks, and all of the costs and expenses incurred by the tax haven, otherwise those payments will be treated as non-deductible for income tax purposes. This will not be applicable when it is demonstrated that the transaction was carried out with a non-related party according to Section 260-1, attaching to the corresponding supporting documentation the supporting documentation that may be considered as appropriate.

Use and availability of comparable information

Comparable information is required in order to determine arm's-length prices and should be included in taxpayers' TP documentation. Decree 3030 of 2013, Section 4, establishes that comparable data should be of the same year as the tested party, however if data of the same year for the comparables is not available, information from prior years is accepted provided that there is supporting documentation that justify its use.

Until fiscal year 2013 it was possible to use Colombian companies as comparables, however due to recent regulations related to the availability of ownership information, current practice is the use of databases of international comparables. In relation to financial companies (i.e. banks and insurance companies) there is still public information available.

Penalties

Section 260-3 of the Tax Code states that if the analysis of a transaction falls outside the range, the price or margin to be considered to be at an arm's-length nature will be the median of such range. In practice, and according to the type of transaction, taxpayers should recognise additional taxable income or reject costs and deductions in the corresponding income tax return if they have failed to follow this rule.

In addition, Paragraph 3 of Literal C of Section 260-11 of the Tax Code states that:

"In accordance with transfer pricing regulations, there will be punishable inaccuracy with the inclusion in the income tax return, informative return, supporting documentation or in reports filed to tax authorities, of false, mistaken, incomplete or disfigured data, and/or the determination of income, costs, deductions, assets, and liabilities in transactions with related parties in accordance to what is established in Sections 260-1 and 260-2 of the Tax Code, with prices or margins that do not agree with those that independent parties will have used in comparable transactions, which derive in a lesser tax or payable value, or in a higher balance in favour for the taxpayer.

The applicable penalty will be the one established in Section 647 of the Tax Code. Penalty included in such Section could be up to 160% of the higher tax".

It is important to bear in mind that amendments to the income tax return can be made only if such return has its statute of limitations open, which in general terms is two years.

Formal penalties for TP rules are established in Sections 260-11 of the Tax Code.

Summary of penalties
Section 260-11, Literal A – Supporting documentation

Reason for penalty		**Penalty**
Late filing	During the 15 working days following the due date	75 Tax Units (TUs) for each working day of delay, but not to exceed 1,125 TUs.
		When transactions carried out with related parties amount to less than 80,000 TUs, the penalty will be of 15 TUs for each working day of delay, but not to exceed 225 TUs.
	After 15 working days following the due date	1,200 TUs for each calendar month or calendar month fraction of delay, but not to exceed 14,400 TUs.
		When transaction carried out with related parties amount to less than 80,000 TUs, the penalty will be of 250 TUs for each calendar month or calendar month fraction of delay, but not to exceed 3,000 TUs.
Inconsistencies	Mistakes in the information, content with information that does not correspond to what is requested or does not allow to verify the application of the TP regime	1% of such transactions' amount, but not to exceed 3,800 TUs.
		When transactions with related parties amount to less than 80,000 TUs, the penalty is not to exceed 800 TUs.

Reason for penalty		Penalty
Omission of information regarding transactions subject to the TP regime	When information is omitted	2% of the amount of the transactions, but not to exceed 5,000 TUs. In addition, the rejection of costs and deductions that were originated in the transactions for which no information was provided.
		When transactions carried out with related parties amount to less than 80,000 TUs, the penalty is not to exceed 1,400 TUs.
	When it is not possible to establish the base amount to determine the penalty	The base amount will be determined by using the information included in the informative return of those transactions that evidence the omission of information. In case it is not possible to establish the base amount from that information, the penalty will be of 1% of the net income registered in the last income tax return filed. If there is no income, the penalty will be of 1% of the gross equity registered in the last income tax return. In any case it is not to exceed 20,000 TUs.
Omission of information regarding transactions carried out with tax havens		In addition to the rejection of costs and deductions that were originated in such transactions, the penalty will be of 4% of the amount of the transactions, but not to exceed 10,000 TUs. In case the omission is rectified before the notification of the Tax Assessment (*'liquidación de revisión'*), the penalty regarding the rejection of costs and deductions will not be applicable.
Reduced penalty		Penalties for inconsistencies and omission of information will be reduced to 50% of the amount established in the Tax Notice or Special Requirement, if they are rectified before the notification of the resolution that imposes the penalty or the Tax Assessment.
Amendment of TP report		When, after a Special Requirement or Tax Notice, the TP report is amended changing the methods, profit margin or the comparability criteria, the penalty will be 4% of the total amount of transactions subject to the TP regime, but not to exceed 20,000 TUs.

Section 260-11, Literal A – Informative return

Reason for penalty		Penalty
Late filing	During the 15 working days following the due date	50 TUs for each working day of delay, but not to exceed 750 TUs.
		When transactions carried out with related parties' amount to less than 80,000 TUs, the penalty will be of 10 TUs for each working day of delay, but not to exceed 150 TUs.
	After 15 working days following the due date	800 TUs for each calendar month or calendar month fraction of delay, but not to exceed 9,600 TUs.
		When transactions carried out with related parties amount to less than 80,000 TUs, the penalty will be of 160 TUs for each calendar month or calendar month fraction of delay, but not to exceed 1,920 TUs.
Inconsistencies	Inconsistencies regarding one or more transactions subject to the TP regime	0.6% of such transactions' amount, but not to exceed 2,280 TUs.
		When transactions carried out with related parties amount to less than 80,000 TUs, the penalty is not to exceed 480 TUs.
		Inconsistencies: data included in the informative return does not match the data included in the TP report.
Omission of information regarding transactions subject to TP regime	When information is omitted	1.3% of the amount of the transactions, but not to exceed 3,000 TUs. In addition, the rejection of costs and deductions that were originated in those transactions for which no information was provided.
		When transactions carried out with related parties amount to less than 80,000 TUs, the penalty is not to exceed 1,000 TUs.
	When it is not possible to establish the base amount to determine the penalty	The penalty will be 1% of net income registered in the last income tax return filed. In case there is no income, the penalty will be 1% of the gross equity registered in the last income tax return. In any case it is not to exceed 20,000 TUs.
Omission of information regarding transactions carried out with tax havens		In addition to the rejection of costs and deductions that were originated in such transactions, the penalty will be 2.6% of the amount of the transactions, but not to exceed 6,000 TUs. In case the omission is rectified before the notification of Tax Assessment, the penalty regarding the rejection of costs and deductions will not be applicable. Likewise, once the Special Requirement is notified, only those costs and deductions for which it can be fully demonstrated that they were established according to the arm's-length principle, will be accepted.

Reason for penalty	Penalty
Not filing the informative return	After the notice in writing, the taxpayer will have 1 month to file it; in case it is not filed, it could not be used subsequently as a proof in its favour, and that fact will be treated as evidence against it and a penalty of 10% of the total amount of the transactions subject to the TP regime will be applicable, but not to exceed 20,000 TUs.
Reduced penalty	Penalties for inconsistencies and omission of information will be reduced to 50% of the amount established in the Tax Notice or Special Requirement, if they are rectified before the notification of the resolution that imposes the penalty or the Tax Assessment.
In the case of financial transactions, particularly loans that involve interest, the base amount for the computation of the penalty will be the amount of the principal and not the amount of the interest.	

Documentation

Formal obligations

Income taxpayers obliged to fulfil TP requirements are those that perform transactions with related parties located abroad and in FTZs that at year-end exceed the established caps of gross equity equal to or higher than 100,000 TUs, or gross income equal to or higher than 61,000 TUs, as well as those taxpayers that engage in transactions with residents domiciled in tax havens, regardless of its gross equity or gross income. For fiscal year 2014 one TU is equivalent to 27,485 Colombian pesos (COP) (adjusted every year by inflation) and approximately 11.45 United States dollars (USD), at an exchange rate of COP 2,400 per USD.

Formal obligations consist of preparing and filing the TP informative return and the supporting documentation, considering the following provisions:

- There is no obligation to prepare and file the supporting documentation when the total amount of the transactions carried out with related parties is lower than 61,000 TUs; nonetheless, those transactions must be included in the informative return.
- There is no obligation to prepare and file the supporting documentation for those types of transactions which annual accrued amount is lower than 32,000 TUs, nonetheless those transactions must be included in the informative return.
- There is no obligation to prepare and file the supporting documentation when the total amount of the transactions carried out with tax havens is lower than 10,000 TUs, nonetheless those transactions must be included in the informative return.

Act 1607 in 2012 introduced the following provisions regarding financial transactions:

- As of fiscal year 2013, it will only be allowed to deduct the interest generated by debts which the average annual amount for the corresponding fiscal year is not higher than the result of multiply by three (3) the taxpayer's net equity at 31 December of the previous year (there are special provisions for some industries). The interest generated by the amount exceeding such limit will not be deductible.

- For those transactions associated to loans that must be included in the informative return as 'interest on loans', when establishing whether the transaction exceeds the caps, it is the amount of the principal that must be considered.
- Interest payments to foreign related parties, domiciled in FTZs or in tax havens that do not fulfil the comparability criteria (principal, term, risk rating, warranty, solvency, and interest rate), will not be deductible, irrespective of the interest rate agreed. Therefore, those transactions will not be considered as loans nor interest, but as capital and dividends.

Following is a short description of the requirements regarding the informative return, and the supporting documentation.

Informative return
Pursuant to the regulatory decree, the return must contain the following:

- Form fully completed.
- Information regarding the identification and location of the taxpayer.
- Information of the identification of the related parties located abroad, in FTZs and tax havens.
- Identification of the type of transactions, methodology used and other factors relevant to determine the prices or profit margins.
- Information about cost-sharing agreements and business restructurings.
- Assessment of penalties, when necessary.
- Electronic signature of the individual that has the legal duty to file the return, the taxpayer, or its representative, or its agents, or the special agent.

Supporting documentation or transfer pricing study
The supporting documentation should be prepared and filed through the Electronic Media and Payment System on a yearly basis and it is generally due on the same date as the return. If applicable to the type of transaction, the supporting documentation must contain among other things the following information:

- Executive summary.
- Functional analysis.
- Industry analysis.
- Economic analysis.

Filing of the informative return and supporting documentation
Generally, due dates for filing the form of the informative return and the supporting documentation are in mid-July of the year following the fiscal year that is reported, and both obligations should be filed through the Electronic Media and Payment System. The form to be used for filing the return is N° 120.

Specific due dates for filing both informative return and supporting documentation for each fiscal year are issued on December of the same year. There is a specific due date applicable to an entity for both the return and supporting documentation depending on the last digit of its tax identification number.

Transfer pricing controversy and dispute resolution

Burden of proof

The TP regulations shift the burden of proof to the taxpayers, since it requires them to support their transfer prices, and to document all their inter-company transactions subject to the rules.

Limitation of double taxation and competent authority procedure

When, according to what is established in an international tax treaty entered into by Colombia, the competent authority of the country that entered the treaty, adjusts the prices or compensation amounts of a taxpayer in that country, and provided that such adjustment is accepted by Colombian tax authorities, the taxpayer in Colombia is allowed to request an amendment to its income return without a penalty that reflects the corresponding adjustment.

Notwithstanding the above, it is necessary to harmonise the statute of limitations of the income tax return in Colombia with what is pursued by the agreements to avoid double taxation in order to be able to request the reciprocal adjustment.

Advance pricing agreements (APA)

As of 1 January 2006, taxpayers can request an APA. These regulations refer to the content duration, time limits so that the APA may by authorised by the tax authorities, time limits so that taxpayers could request an APA, modification of an APA and cancellation of the agreement, among others.

Among the regulations it is important to mention the following:

- The APA could produce effects in the year it is signed, the previous one and up to the three subsequent fiscal years.
- The request of an APA must be in writing and the tax authority will have a maximum term of nine months in unilateral agreements in order to perform the corresponding analysis, request and receive amendments and clarifications, and to accept or reject the application. For bilateral or multilateral agreements, the term will be jointly defined between the competent authorities.
- The taxpayer must present an annual report regarding the transactions covered by the agreement.

Practice

Tax authorities have become more aggressive and have improved their TP knowledge.

Although TP audits have focused on formalities, they are increasingly focusing on i) taxpayers failing to fulfil TP rules, ii) informative return formal penalties (i.e. late filing), iii) requests for income-tax return amendments for failure to follow the arm's-length principle, iv) inter-company services' fees, formalities to deduct, and supporting documents to prove the benefit and rendering of the service, v) information regarding comparable companies, vi) extraordinary adjustments applied to the tested party, vii) inter-company financial transactions, viii) transfer of intangible property, ix) royalty payments, and x) method selected to conduct the analysis.

The audit procedure
Tax authorities use the regular or standard audit procedure, such as onsite examinations and/or written requests. During the examination, the tax authorities may request additional information and must be allowed to have access to the company's accounting records. In general, the audit procedure is as follows:

- Ordinary tax notice: in general, tax authorities grant 15 calendar days to answer it.
- Special tax notice: taxpayers have three months to answer it and when answered, tax authorities may expand it by granting additional time to answer it.
- Official assessment: taxpayers may appeal (two months) or file a complaint before a tax court (four months).
- If the taxpayer appeals, tax authorities have one year to issue a tax authority's final judgment. Once the tax authority's final judgment is issued, the taxpayer has four months to file a complaint before a tax court.
- Once the complaint is in a tax court, the process may take up to two years.
- If the tax court's decision is adverse to the taxpayer, it may file a complaint before a final tax court. This process may take approximately three to five years.

Liaison with customs' authorities
There are no records or evidence of any direct communication between customs and tax authorities regarding TP.

Joint investigations
There have been no requests to other tax authorities for specific information concerning TP.

Comparison with OECD Guidelines

OECD issues
Although Colombia is not currently a member of the OECD, the tax authorities have generally adopted the TP Guidelines for Multinational Enterprises and Tax Administrations, published by the OECD, as a specialised technical reference and not as a supplementary source of bylaw interpretation.

Since Colombia has been invited to be a member of the OECD, authorities are making an important effort in aiming to introduce into its legislation up to date tax provisions like PE rules issued in December 2012, which may lead to expect future developments like Base Erosion and Profit Sharing (BEPS), and additional intangible property provisions.

Overall, Colombian TP regulations follow OECD Guidelines.

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Congo, Democratic Republic of

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Overview

Transfer pricing (TP) documentation requirements have been newly introduced by the Finance Law applicable since 1 January 2015.

TP is the new area of focus for the Tax Administration in the Democratic Republic of Congo (DRC). We are of the opinion that for the coming fiscal year, the Tax Administration will strengthen the legislation and TP audits will commence.

Country	**Democratic Republic of Congo**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	N0
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	N/A
When must TP documentation be prepared?	TP documentation shall be available and can be requested at any moment by the tax authorities. In case of lack of the said supporting documentation, or in case the documentation is partial, the taxpayer will have a period of 20 days to produce the required documents.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No

Congo, Democratic Republic of

Country	Democratic Republic of Congo
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	Transfer pricing adjustments may be made under the domestic law. In this context, any amount paid by a DRC entity to an entity abroad that is directly or indirectly related to the DRC entity and which is above an arm's-length value and likely to be an abnormal management act, may be added to the revenue of the DRC based company for the purpose of corporate Income tax. There are not specific penalties provided in the Finance Law. General penalties on income-tax adjustments apply.

Introduction

In order to fight against illicit transfers of profits, the Congolese Finance Law Transfer Pricing documentation requirements for 2015 has provided rules pertaining to TP requirements.

These rules establish an obligation for companies located in the DRC which are under the control of a company located abroad, to have a supporting documentation on TP regarding the transactions realised by companies belonging to the same group. The said documentation shall contain both general and specific information.

Penalties

For TP, general penalties on income tax adjustments apply.

The reassessed amount can be considered as distributed profit and consequently subject to 35% corporate income tax.

Documentation

The following information has to be reported in the TP documentation:

General information

General information includes:

- A general description of the activities carried out, including changes that occurred during the years already audited.
- A general description of the legal and operational structures of the group of related companies with an identification of associated group companies engaged in the transactions.

- A general description of functions performed and risks assumed by the related companies whenever they affect the audited company.
- A list of the key intangible assets including patents, trademarks, trade names and know-how, in relation to the audited company.
- A general description of the TP policy of the group.

Specific information

The tax authorities can also request that specific documentation on the audited company include:

- A description of the activities carried out including changes occurred during the audited years.
- A description of transactions carried out with related companies including the nature and the amounts of the cash flow including royalties.
- A list of cost-sharing agreements and a copy of the preliminary agreements on TP concluded in compliance with the conditions determined by a decree and advance rulings on the determination of transfer prices affecting the turnover of the audited company.
- A presentation of methods for determining of transfer prices in accordance with arm's-length conditions including an analysis of the functions performed, assets used, and risks assumed as well as an explanation for the selection and application of the methods used.
- An analysis of comparative items considered relevant by the company when the method was chosen.

Transfer pricing controversy and dispute resolution

TP requirements have been newly implemented. We do not have any past experience on TP dispute resolution.

Congo, Democratic Republic of

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Congo, Republic of

PwC contact

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Overview

Transfer pricing (TP) is the new area of focus for the Tax Administration in the Republic of Congo (Congo) – up to now, there has been no TP audits.

We are of the opinion that for the coming fiscal year, the Tax Administration will strengthen the legislation and TP audits will commence.

Country	**Congo**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Before a tax audit, when requested by the Tax Administration.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes

Congo, Republic of

Country	Congo
How are penalties calculated?	In addition to applying the corporate income tax on the amount of the TP adjustment, penalties of 100% can apply. 20% withholding tax (WHT) can also apply on the TP adjustment, considered to be distributed profit.

Introduction

In order to fight against illicit transfers of profits, the Congolese General Tax Code (GTC) has provided rules implementing TP provisions in its section 120. These rules follow the TP regime developed by the Organisation for Economic Co-operation and Development (OECD). According to said rules, companies and multinational groups should determine the price of their internal transactions according to the arm's-length principle. It is up to the Tax Administration to examine the overall relationship between the related entities to determine whether their results are consistent with this principle.

The Finance Law for 2012 reinforces the provision of Article 120 by establishing an obligation of production of TP documentation by certain taxpayers (where gross turnover exceeds 100 million Central African CFA francs [XAF]) during tax audits.

The GTC (Finance Law for 2012) also provides that the request for information on TP should occur at the request of the Tax Administration or only in the context of general tax audit.

It is expected that a Ministerial Order providing the terms, conditions and modalities for implementation of the request by the tax authorities for information relating to the determination of TP will be available very soon.

Finally, the Tax Administration accepts the procedure of advance pricing agreements (APA). As a matter of fact, after submission by a taxpayer of an APA, the Tax Administration should reply within three months, if the taxpayer is considered to be in good faith.

Legislation and guidance

General context

Article 120 of the General Tax Code, Volume 1, provides that:

"For the assessment of the company tax payable by companies which are controlled by, or which control an undertaking established outside Congo, the profits indirectly transferred to the latter by increasing or reducing the purchase or selling price, or by any other means, shall be incorporated in the results shown by their accounts.

The same shall apply to undertakings which are controlled by an undertaking or group likewise in control of undertakings established outside Congo".

The specific context:
Article 120 D of the GTC Volume 1 establishes a new requirement, which provides for the production of certain TP documents by certain taxpayers during tax audits.

These taxpayers are henceforth required to submit to the Tax Administration, from the date of commencement of the tax audit carried on by the Tax Administration, documentation that justifies the TP policy applied in transactions of any nature realised with legal entities established or incorporated outside Congo, and which are dependent or have control of businesses located in Congo.

The same applies to transactions with companies located in Congo and which are under the control of a company or group also having control over companies located outside Congo.

Penalties
For TP, general penalties on income-tax adjustments apply.

In addition, the reassessed amount can also be considered as distributed profit and consequently, subject to 20% WHT on dividend.

Documentation
Since 2012, Article 120 D of the GTC Volume 1 rendered compulsory for companies (having total turnover above or equal to XAF 100 million) to provide certain documentations at the request of the administration, when in the course of an audit, elements show an indirect transfer of profits.

This documentation includes:

- A general description of the activities carried out including changes in activity during the audit period.
- A general description of the legal and operational structures of the group of related companies with identification of associated group companies engaged in the transactions.
- A general description of the functions performed and risks assumed by the related companies when they affect the company audited.
- A list of key intangible assets including patents, trademarks, trade names and know-how in relation to the audited company.
- A general description of the TP policy of the group.

The tax administration can also request that specific documentation on the audited company should include:

- A description of the activities carried out including changes in activity during the audit period.
- A description of transactions carried out with related companies including the nature and amount of income including royalties.
- A list of cost-sharing agreements and a copy of the preliminary agreements on TP and advance rulings on the determination of transfer prices affecting the turnover of the audited company.

- A presentation of methods for determining transfer prices in accordance with the arm's-length principle including an analysis of the functions performed, assets used and risks assumed, and an explanation for the selection and application of the methods used.
- An analysis of comparative items considered relevant by the company when the method was chosen.

Transfer pricing controversy and dispute resolution
Up until now, we do not have any past experience on TP dispute resolution in Congo.

For the time being, in order to agree on the best method to adopt, the tax authorities accept the application of a unilateral APA that is adapted for the Congolese environment.

Comparison with OECD Guidelines
Congo is not an OECD member; however the TP provisions in the GTC follow OECD's Guidelines.

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Costa Rica

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Overview

Decree No. 37898-H establishes the 'Transfer Pricing Provisions' and mandates taxpayers in Costa Rica to evaluate the prices agreed with its related parties, whether residents or non-residents, on the transfer of goods or services in compliance with the economic reality and arm's-length principle, based on the allowed methods for transfer pricing (TP) valuation.

The Decree provides further regulations to the initial TP Guideline No. 20-03, which established the arm's-length principle, based on the principle of economic reality in 2003. These new regulations apply to all Costa Rican companies that carry out transactions with related parties locally and abroad. Therefore, entities should perform an analysis that will allow them to evaluate which transactions comply with the arm's-length principle (formerly defined as Normal Market Value in the Interpretative Guideline 20-03).

Country	**Costa Rica**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Usually after end of fiscal year
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Not required yet*
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes

Costa Rica

Country	Costa Rica
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	2% of gross revenue of prior period

*Detailed information of TP return not issued yet.

Introduction

On 10 June 2003, the General Tax Directorate enacted the Interpretative Guideline No. 20-03 on 'Transfer Pricing Fiscal Treatment in accordance to Market Value'. This Interpretative Guideline empowered the Tax Administration to assess the prices of inter-company transactions including those carried out with non-resident and resident related parties. It also requires the compliance with the arm's-length principle in accordance with the principle of economic reality. The legal basis of this Interpretative Guideline is included in Articles 8 and 12 of the Tax Code of Policies and Procedures.

Costa Rican companies experienced difficulties in applying Interpretative Guideline No. 20-03, because it was unclear, which called for a more detailed regulation. As a result, on 13 September 2013, Decree No. 37898-H was enacted to address the gap. On 10 March 2015, the Executive Power issued a draft Income Tax Reform bill that includes the arm's-length principle previously defined in the Interpretative Guideline No. 20-03. The bill also states that the Executive Power will develop additional transfer pricing rules in order to comply with TP. In the meantime, taxpayers need to comply with the arm's-length principle considering the dispositions included in the Decree No. 37898-H.

Looking to 2015, due to the effect of the new rules, companies should conduct formal TP studies. Although Costa Rican legislation does not specify any method for TP audit purposes, the burden of proof lies on the taxpayer, who shall demonstrate that their transfer policy complies with the regulations. Specific obligations and use of TP methods are contained in the Decree.

Legislation and guidance

Costa Rican TP rules are based on the internationally accepted arm's-length principle. Although this legislation does not refer to the Organisation for Economic Co-operation and Development (OECD) Guidelines, the accepted methods by Costa Rican rules are consistent with the OECD Guidelines.

For income tax purposes and based on the free competition and economic reality principles (Article 8 of the Code of Tax Norms and Procedures), those that carry out inter-company transactions are obliged to determine their income, expenses and deductions, based on similar operations carried out between independent parties. This procedure will only apply provided the inter-company transactions result in a tax payment decrease or deferral.

Pursuant to the Decree, 'related parties' are considered to be individuals or juridical persons that directly or indirectly participate in the management, control or capital of the taxpayer, or that – due to other reasons – may influence systematically in the pricing decisions. Individuals or entities domiciled in jurisdictions without mechanisms to exchange tax information are also presumed to be related parties.

The Decree also created advance pricing agreements (APAs) between the taxpayer and the Tax Administration, which will be valid for three years, once approved. The Tax Administration is currently working on additional resolutions for APA implementation.

Comparability

The Decree establishes the need for a comparability analysis (functional analysis), considering the following elements:

- Characteristics of the operations, products or services.
- Functions or activities including assets and assumed risks.
- Contractual terms and conditions.
- Economic circumstances.
- Business strategies.
- Identification of prices and comparable transactions (internal and external).

Methods

The methods for the determination of prices in comparable operations are:

- Comparable uncontrolled price (CUP) method.
- Cost plus (CP) method.
- Resale price method (RPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).

Penalties

The Decree did not establish specific penalties for failure to comply with the documentation requirements; however, 2% of the gross revenue of the last period with a minimum of 10 base salaries and a maximum of 100 base salaries could be applied according to tax rules, in case of filing informative return after the due date or not providing information required by the Tax Administration (as example support documentation).

Documentation

For tax years beginning after 13 September 2013 (effective date of the Decree) and on annual basis thereafter, an informative return shall be filed by the following taxpayers:

- Those that carry out national or cross-border transactions with related companies.
- Those that are classified as large-scale taxpayers, large regional companies, or classified under the Free Zone Regime.

However, the decree indicates that all taxpayers who perform transactions with related parties must determine their TP reasonably and verify if they are relevant, for tax purposes, in accordance with the arm's-length principle; therefore, it will be reasonable for all taxpayers to keep the relevant TP documentation for their transactions with related parties.

Although the Decree establishes that the valuation documentation for inter-company transactions shall be kept in Spanish and for a five-year period, the Tax Administration will create a more specific guideline in this regard. The information and documentation to be kept by the taxpayer includes:

- The activities and functions carried out by the taxpayer.
- The list of fixed assets used in inter-company operations, to the extent that they are economically significant in the analysis of transactions with related parties.
- Activities' inherent risks, such as commercial, financial, operational, transformation, marketing and sale of the goods and/or services performed by the taxpayer, to the extent that they are relevant to the analysis of transactions with related parties.
- Overview of the organisational and operational structure of the taxpayer and the group including tasks and roles of the group's key members.
- Name, tax ID and tax domicile of the taxpayer residing in Costa Rica, as well as, the related parties involved in inter-company transactions.
- Information about transactions performed with related parties, the amount and currency used.
- Financial statements for taxpayer's fiscal year in accordance with International Financial Reporting Standards.
- Contracts and/or agreements with related entities if these are relevant for an analysis of the operations.
- Method(s) used for price determination in accordance with the arm's-length principle. There must be an indication of the approach and objective elements considered to determine that the method used is the most appropriate for the operation or business.
- Identification of each of the operations or comparable companies selected including: the identification of the sources of information of which the comparable was obtained; details of the elements, quantification and the methodology used to practise the necessary adjustments on the comparable selected; details of the non-selected comparable indicating the reasons and considerations for its disposal; description of the business and the characteristics of that of comparable companies.
- Specific information about whether the related parties abroad are the subject of TP assessment, or if these are settling any dispute of a fiscal nature on TP before the competent authorities or courts, as well as the status of the said dispute. In the case of final judgment by relevant courts or resolutions issued by competent authorities regarding a TP dispute, copies of the said documents shall be kept.
- Information and supporting documentation that is relevant to each type of operation and by each related party.

As previously mentioned, the Decree did not establish specific penalties for failure to comply with the documentation requirements; however, 2% of the gross revenue of the last period with a minimum of 10 base salaries and a maximum of 100 base salaries could be applied according to tax rules in case of filing informative return after the due date or not providing information required by the Tax Administration (as example support documentation).

Transfer pricing controversy and dispute resolution

Constitutionality of TP Guideline No. 20-03, issued in 2003, was questioned before the Constitutional Court of Justice, due to the lack of information, such as the methodology and the detail of the information required regarding related parties; however, the Constitutional Court rejected the action.

Since 2003, the Tax Administration has carried out TP adjustments to Costa Rican taxpayers; some of them have appealed, but many adjustments have been confirmed by the Judicial Authority.

The burden of proof lies on the taxpayer to demonstrate that their TP policies comply with the general rules and that the transactions have been conducted in accordance with the arm's-length principle.

Comparison with OECD Guidelines

Costa Rica became a signatory of some of the OECD's resolutions passed last year including the Declarations on International Investment and Multinational Enterprises, on the Future of the Internet Economy, and Propriety, Integrity and Transparency. Costa Rica's full integration to the OECD will be discussed in 2015.

Costa Rica

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Croatia

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Overview

There have been no major changes regarding transfer pricing (TP) in the past year. Transfer pricing provisions in Croatia were introduced through the Corporate Income Tax (CIT) Act on 1 January 2005, but only in recent years have the Croatian tax authorities recognised the importance of TP. The tax authorities now have an experienced TP team with access to the Orbis database, as well as an increased number of audits related specifically to TP.

Country	**Croatia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No, but a list of activities that must be performed to determine whether a transaction is performed at arm's-length principle is prescribed.
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes (under certain conditions)
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	At the tax authority's request (in practice, the documentation should be available at the time of CIT return submission).
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Only if tax authority's request is received.

Croatia

Country	Croatia
Penalties	
Are there fines for not complying with TP documentation requirements?	No, but the tax base adjustments for transfer prices and fines, if taxpayer fails to assess his tax liability, are prescribed.
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Penalties are prescribed by the CIT Act.

Introduction

Generally, Croatian TP regulations mostly rely on the arm's-length principle and methods specified by the Organisation for Economic Co-operation and Development (OECD) Guidelines.

Legislation and guidance

Transfer pricing regulations' application

The TP regulations are applied to all cross-border transactions between domestic entities and their related parties, as well as to transactions between resident related parties, where one party has:

- preferential tax status, i.e. pays profit tax at the decreased tax rate, and
- the right to utilise tax losses carried forward from past periods.

Legislative framework

Transfer pricing rules are prescribed by the CIT Act and by the CIT Rulebook.

According to the CIT Act, the following methods can be used to determine the arm's-length price:

- The comparable uncontrolled price method (CUP).
- The resale price method (RPM).
- The cost-plus (CP) method.
- The profit split method (PSM).
- The net-profit method (which is equivalent to the transactional net margin method (TNMM) under the OECD Guidelines).

The CIT Rulebook provides a list of activities that should be performed in order for taxpayers to provide the information required for recognition of the business relations between related entities.

The General Tax Act provides a definition of the related companies.

Arm's-length principle

Prices between a Croatian entity and its foreign-related party or domestic-related party (under certain conditions) must be charged at arm's length. The prices between related entities that are different from the market prices will not be recognised for tax purposes.

Definition of related parties
The General Tax Act defines affiliated companies as entities that in their relationship to each other can stand as:

- a company that has a majority share or majority vote in another company
- a subsidiary and parent company
- an affiliate group of companies (concern)
- companies with mutual shares, where every company has more than 25% of shares in another company, and
- companies connected by entrepreneurial agreements, such as: contracts related to the provision of business management to a company, contracts on profit transfer and other entrepreneurial agreements entered into the court registry.

In addition, related persons as legally independent companies which, in their mutual relations, satisfy the following:

- Two or more natural or legal persons who, for carrying out the obligations under the tax–debt relationship, constitute a single risk because one of them, directly or indirectly, holds control in the others or, directly or indirectly, has significant influence on the others.
- Apart from control of significant influence, related entities will also be those where deterioration or improvement of the economic and financial condition of one person can cause the deterioration or improvement of the economic and financial condition of others, because there is a possibility of the transfer of losses, profits or payment capability.

Resources available to the tax authorities
The tax authority has access to the Orbis database. The tax authority is also known to use publicly available, relevant data from other companies that operate in the Croatian market.

Limitation of double taxation and competent authority proceedings
Croatia has signed 61 double tax treaties (DTT) – 57 are currently in force, a DTT with India will be effective as of 2016, and three DTTs (Luxembourg, Portugal and Turkmenistan) are currently pending.

Other regulations
There are no other regulations prescribed in Croatian legislation, but the OECD Guidelines can be used as a general guide. Additionally, the tax authority has issued the Guidebook for the Surveillance of Transfer Pricing. It is not a binding regulation and its purpose is to serve as a guideline for the tax authority's inspectors during the TP surveillance. However, it can also be used as a guideline for taxpayers.

Penalties
Current Croatian legislation does not proscribe additional tax and penalties in relation to TP. However, the legislation does provide a tax base adjustments option. Furthermore, a taxpayer could be fined from 2,000 Croatian kuna (HRK) to HRK 200,000 if they fail to assess their tax liability in accordance with the CIT Act and the responsible taxpayer could be fined from HRK 500 to HRK 20,000.

Croatia

Documentation
Transfer pricing rules are prescribed by the CIT Act and by the CIT Rulebook.

Croatia does not currently have formal transfer pricing documentation (TPD) requirements per se. However, the Croatian CIT Rulebook, Article 40, provides a list of activities that must be performed to determine whether a transaction is performed at regular market prices. Those activities include:

- Provision of information about the group, the position of the taxpayer in the group and the analysis of related transactions, i.e. general information about the group and the specific information about the taxpayer.
- Identification of the selected method, a description of reviewed information, the methods and analyses used to determine the arm's-length price and the rationale for selecting the specific method.
- Documentation about the assumptions and valuations made in the course of determining the arm's-length price (which would underline benchmark analysis, functional analysis and risk analysis).
- Documentation about all calculations made in the course of the application of the selected method in relation to the taxpayer and any comparables used in the analysis.
- Updated documentation that relies on a prior-year analysis, containing adjustments because of material changes in relevant facts and circumstances.

Deadline for submitting the TP documentation
Although the tax regulations state that TPD should be available on the tax authority's request, the recent tax authority's initiative demonstrates that the documentation should be available at the time of CIT return submission, which is four months from the financial year-end.

Transfer pricing controversy and dispute resolution
Tax audit procedures
In practice, in order to be fully recognised for tax purposes, all costs incurred between two companies must meet the following conditions:

- They should be proven as necessary and provided for the benefit of the local company.
- The description of the services on the invoice must correspond to the services actually provided.
- The invoice must be supported with documentation of services provided (e.g. in case of consulting or advisory activities, this may include various correspondence, emails, reports, projects, etc.).
- The value on the invoice should be an arm's-length price.

Currently, there is no special tax audit procedure specific to TP that differs from the regular tax audit procedure.

Legal cases
There are no legal cases in Croatia related to TP.

Burden of proof
The burden of proof lies with the local taxpayer.

Advance pricing agreements (APAs)
Croatia does not have an APA programme in place.

Revised assessments and the appeals' procedure
The standard legal procedure is for the tax authority to issue a resolution at the conclusion of the tax audit (i.e. first instance).

Prior to the issuance of the resolution, the tax authority issues 'tax audit minutes'. The taxpayer has an opportunity to object to the tax audit minutes and make written comments/remarks about the statements made in the minutes. Subsequently, the tax office issues the written resolution.

If, at the first-instance level, the tax office does not accept the taxpayer's objection to the resolution, the taxpayer can appeal to the Central Tax Office (i.e. second instance). In the second instance, the Central Tax Office will issue a second-instance resolution. With this second-instance resolution, the Central Tax Office can resolve the conflict itself, or prepare instructions for the first instance as to how to resolve the conflict.

In the event that the second-instance resolution is unfavourable and not acceptable to the taxpayer, the taxpayer may initiate legal proceedings at the Administrative Court.

Comparison with OECD Guidelines
The TP provisions generally reflect the arm's-length principle and methods provided by the OECD Guidelines.

Croatia

29.

Czech Republic

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Overview

The number of transfer pricing (TP) inquiries has increased in recent years, and the Czech tax authorities are becoming more confident in this area and the level of sophistication of the tax authorities is constantly increasing.

As of 2012, a new Specialised Financial Office was established, focusing on companies with turnover exceeding 2 billion Czech korun (CZK); banks including branches of foreign banks; credit unions; insurance and reinsurance companies including branches of foreign insurance and reinsurance companies; and companies that form a VAT group with entities defined above. The Specialised Financial Office has audit teams dedicated to TP. In 2015, the Specialised Financial Office announced new waves of tax audits focused on TP of multinational companies.

These developments prove that the Czech tax administration recognises the importance of TP, which has resulted in an increase in the number of tax audits that focus on related-party transactions, particularly those involving services, intangibles, low-risk functions and losses. The Czech tax administration uses a systematic approach to review transfer prices through field investigations (i.e. data collection and interviews at the company premises), risk assessment tools and questionnaires to select entities and specific transactions for a tax audit.

In connection with an increased focus on TP, taxpayers are obliged to file a separate disclosure form on transactions with related parties, together with the corporate income tax return for the taxable period starting 1 January 2014 and later periods. The disclosure reporting of related-party transactions is used by the Czech tax authorities in the risk assessment when selecting entities for a tax audit.

Further, there is a growing trend in relying on the advance pricing agreement (APA) process with the Czech tax authorities to resolve TP uncertainties.

We have seen that the number of TP audits by the Czech tax authorities has significantly increased recently. It is also expected that the audits will be more focused on 'high risk' areas and specific transactions selected through the disclosure reporting.

Czech Republic

Country	Czech Republic
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Upon request during a tax audit
Must TP documentation be prepared in the official/local language?	Yes (English may be acceptable)
Are related-party transactions required to be disclosed on the tax return?	Yes (starting from tax period 2014)
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Introduction

The Czech Republic has been a member of the Organisation for Economic Co-operation and Development (OECD) since 21 December 1995. The OECD Guidelines on TP were translated into the Czech language and published by the Czech Ministry of Finance in 1997 and 1999. Although the OECD Guidelines are not legally binding, they are generally accepted by the Czech tax authorities.

In addition, as a member of the European Union (EU), the Czech Republic has adopted the EU TP documentation Code (master file approach). However, it is at the taxpayer's discretion to follow the code.

Taxpayers can submit a written request to the Czech tax authorities for an APA (i.e. a binding TP ruling), which has become a regular tool for managing TP risks.

Legislation and guidance

Arm's-length principle in Czech tax legislation

Czech TP legislation covers transactions between companies as well as individuals and applies equally to domestic and cross-border transactions. The legislation contains a general definition of the arm's-length principle, which basically reflects the arm's-length principle in the OECD Guidelines.

The legislation states that a taxpayer's tax base should be adjusted for any related-party transaction undertaken by the taxpayer in which the price differs from what would have been agreed between unrelated parties in current business relationships under the same or similar terms (conditions).

Definition of related parties
Based on Czech tax legislation, parties are considered to be related if one party participates directly or indirectly in the management, control, or capital of the other, or if a third party participates directly or indirectly in the management, control, or capital of both of them, or if the same persons or their close relatives participate in the management or control of the other party (excluding the situation where one person is a member of the supervisory boards of both parties). Participation in management suffices for the assumption of a relationship, even without equity ownership. Participation in control or capital means ownership of at least 25% of a company's registered capital or voting rights. Individuals are related if they are close relatives. Parties are also deemed to be related if they enter into a commercial relationship, mainly for the purpose of reduction of the tax base (or increase of a tax loss).

Methods for determination of the arm's-length price
In general, there are no provisions in Czech tax legislation on how an arm's-length price should be determined in related-party transactions. However, as mentioned above, the OECD Guidelines are generally accepted by the Czech tax authorities. It is therefore recommended to apply the methods described in the OECD Guidelines.

Czech transfer pricing guidelines
In accordance with the guideline of the Czech Ministry of Finance D-332 (regarding use of the international standards for taxation of transactions between related parties), followed by the guidelines of the Czech Ministry of Finance D-333 (regarding TP APAs) and D-334 (regarding scope of TP documentation), Czech companies should follow the principles of the OECD Guidelines.

Investment incentives
Currently, the Czech Government gives the opportunity for manufacturing companies, technology centres and strategic services investing in the Czech Republic to participate in an investment incentives' programme. The investment incentives' package contains various benefits such as a tax holiday.

Czech tax legislation contains a specific provision on the interplay between a tax incentive and TP. Based on this provision, if a company that was granted investment incentives does not comply with the arm's-length principle, it may lose the granted tax incentive in the respective year. This may result in suspension of the tax relief and assessment of severe penalties. Therefore, the Czech tax authorities are highly focused on TP when examining companies that use investment incentives.

Thin capitalisation rules
A thin capitalisation provision is also included in Czech tax legislation. The main rules are outlined below:

- The debt-to-equity ratio for related-party loans to equity is 4:1 (6:1 for banks and insurance companies). Unrelated-party loans (e.g. bank loans) are not subject to thin capitalisation.
- The tax deductibility test applies to interest as well as to other financial costs on loans (i.e. interest plus other related costs such as bank fees, etc.).
- Financial costs paid on profit participating loans are fully tax-non-deductible.
- Back-to-back financing (i.e. credits and loans between related parties provided through an unrelated intermediary, such as a bank) is also subject to thin capitalisation rules.

Penalties

If the tax authorities successfully challenge a company's transfer prices, then additional tax, a penalty and interest on late payments may be due.

With effect from 1 January 2011 (for tax due after 1 January 2011), the penalties and interest on late payments are calculated as follows:

- A penalty in the amount of 20% applies if tax is increased or a tax deduction is decreased as a result of the tax audit.
- A penalty in the amount of 1% applies if a tax loss is decreased as a result of the tax audit.

In addition to the penalty, interest on late payments applies. Interest is calculated as the Czech National Bank's repo-rate (effective on the first day of the relevant half-year) increased by 14%. No penalty applies if the taxpayer reassessed the tax base voluntarily in an additional tax return (only interest on late payment applies in that case).

Documentation

General rules

Czech tax legislation does not prescribe any obligation to maintain any TP documentation (including preparation of a benchmarking study, or a functional and risk analysis). Nevertheless, documentation proving that the arm's-length principle was followed in related-party transactions is typically required by the Czech tax authorities during a potential tax audit. It is therefore highly recommended that such documentation be prepared in advance and that the TP methodology applied in transactions with related parties be properly documented.

In addition, as a member of the EU, the Czech Republic has adopted the EU TP documentation Code (master file approach). However, it is at the taxpayer's discretion to follow the Code.

Based on the legally non-binding guideline D-334 on TP documentation, issued by the Czech Ministry of Finance, documentation for TP should contain at least the following information:

- Master file:
  - Information about the group (business description, organisational structure, inter-company transactions, functional and risk profile of companies within the group, etc.).
- Local file:
  - Detailed description of the business and business strategy.
  - Description of the business transactions in which the above company participates.
  - Benchmarking analysis including a functional and risk analysis.
  - Information about the TP policy and selection of the method.
  - Relevant information on internal and/or external comparables if available.
  - Description of the role the company plays in the group's inter-company TP policy.

The above contents should be sufficient for the tax administrator to determine whether the company acts in compliance with the arm's-length principle. The documentation is expected upon request during audit.

Low-value adding services
Starting from 1 January 2013, a guideline D-10 applies, which aims to reduce the administrative burden of taxpayers in connection with the preparation of TP documentation for intragroup services with low added value. Both concerned parties may prepare documentation, e.g. without functional and risk analysis and without justification of the amount of the set mark-up or analysis of the market, provided that they comply with the following criteria:

- Value of the intragroup services will not exceed 10% of the turnover of the provider.
- Provided services will not exceed the amount of CZK 50 million.
- The costs related to the receipt of the service will not be higher than 20% of the total operating costs of the recipient.

The Czech tax authorities consider the mark-up in the range of 3–7% of costs to be applicable when using comparable profits method (CPM) in normal business relations.

Corporate income tax return disclosure form
The Czech tax administration has introduced a new reporting obligation for the legal entities that participate in transactions with related parties. The taxpayers are obliged to file a separate disclosure form on 'Overview of Transactions with Related Parties', together with the corporate income tax return for the taxable period starting 1 January 2014 and later periods.

The disclosure reporting of related-party transactions is required for the legal entities (except banks, insurance companies and permanent establishments of non-residents) that meet at least one of the following conditions for the statutory audit in the respective taxable period:

- Total assets exceeding the amount of CZK 40 million (approx. 1.5 million euros [EUR]).
- Net turnover exceeding the amount of CZK 80 million (approx. EUR 3 million) per annum.
- Average number of employees exceeding 50.

Furthermore, the taxpayer should participate in at least one transaction with its related party while at the same time:

- the related party has its registered seat outside the Czech Republic, or
- the taxpayer reported loss in the respective taxable period, or
- the taxpayer is a recipient of investment incentives.

A separate disclosure form should be prepared for each related party, notwithstanding the number or materiality of transactions with that particular related party. The disclosure form includes basic information about the related party, its name and place of residence (i.e. country) and includes the following information regarding the (purchase/sale) volume of transactions with the related party:

- Long-term tangible, intangible and financial assets.
- Stock of materials, products and goods.
- Services.
- License fees (including software).
- Interests.
- Financial credit instruments.
- Shares of profit.
- Provision/receipt of gratuitous performance (Yes/No).
- Use of cash-pooling (Yes/No).
- Receivables and payables with related parties.

The disclosure reporting of related-party transactions will be used by the Czech tax administration in the risk assessment when selecting entities for a tax audit.

Reporting under the Commercial Code

The rules and regulations relating to groups of companies including reporting requirements are also included in the Czech Commercial Code. Group companies may conclude a controlling agreement listing the companies that are subject to common management by the controlling company. In the absence of such an agreement, the new reporting requirements impose an obligation on companies having a common majority shareholder to report intragroup transactions.

A document on intragroup transactions is to be prepared as part of the annual report and filed with the relevant commercial court. This document must outline all transactions carried out in the fiscal year between the subsidiary company and the majority shareholder, and also with any sister company. There are no guidelines in the legislation as to what level of detail is required. The document is available to the public including the Czech tax authorities and minority shareholders, which increases the risk of TP investigations. The report on intragroup transactions is also subject to a statutory audit review.

Transfer pricing controversy and dispute resolution

Tax audit procedures

Obligations of the taxpayers

Based on the Tax Procedure Code, which governs tax audit procedures, the taxpayer has two main obligations:

- To declare the tax liability to the tax authorities in a tax return.
- To be able to substantiate the liability declared.

In principle, the tax authorities may request that the taxpayer provide evidence to substantiate all facts relevant to the tax return. This also applies to documentation on the taxpayer's approach to TP.

Approach of the tax authorities
In practice, rather than requesting general information, the authorities will specify their requirements. They must grant the taxpayer sufficient time to compile the required information (although practice shows that in a TP inquiry situation, this might be an issue, given the complexity of TP and the documentation required).

In cases where the tax authorities have requested evidence to substantiate items included in the tax return, it is the tax authorities themselves that decide whether that evidence is adequate. Where it is considered inadequate, the tax authorities may reassess the taxpayer's liability on the basis of their own sources of information, such as third-party valuations, or information obtained from other taxpayers' returns or investigations.

However, in order to be able to make an assessment, the tax authorities should have a reasonable basis to challenge the declared tax liability. In TP disputes, they should primarily:

- provide sufficient evidence that the arm's-length principle was not followed, and
- demonstrate that, as a consequence of non-compliance with the arm's-length principle, the taxpayer has declared an incorrect low-tax liability.

Negotiations between the taxpayer and the tax authorities on the tax liability are rare (e.g. they may occur when the taxpayer cannot substantiate the declared liability and the tax authorities cannot obtain adequate evidence from their own sources to issue a reassessment).

Burden of proof
The burden of proof effectively lies with the taxpayer. In order to mount a challenge, the tax authorities must demonstrate that there is some basis for that challenge. The tax authorities should present the price that they believe is arm's length (and differs from the taxpayer's price). The tax authorities should also provide details on how they construed the price, what data they used, etc. It is the taxpayer who must then provide the evidence to refute the challenge and explain the difference in the prices.

Advance pricing agreements
Based on the Czech Income Taxes Act, if a company is in doubt as to whether the method used for determining the prices applied in existing or future transactions is in compliance with the arm's-length principle, it can submit a written request to the Czech tax authorities for an APA (i.e. a binding TP ruling).

Practical experience shows that the average time needed for processing an APA in the Czech Republic is approximately eight months. So far, mostly unilateral APA requests have been filed along with several bilateral APA requests.

Comparison with OECD Guidelines
The legislation contains a general definition of the arm's-length principle, which basically reflects the arm's-length principle in the OECD Guidelines. Although the OECD Guidelines are not legally binding, they are generally accepted by the Czech tax authorities. There are no specific provisions in the Czech tax legislation that would be contrary to the principles of the OECD Guidelines.

Czech Republic

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Denmark

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Overview

Transfer pricing (TP) is one of the highest priority issues for the tax authorities in Denmark. The level of tax audits is increasing, as are the number of adjustments. In previous years, the Danish Tax Authorities (DTA) have issued a record number of taxable income increases in TP cases. In the last two years alone, the DTA issued TP adjustments for nearly 40 billion Danish kroner (DKK). In 2014, the DTA issued 76 TP adjustments. This is nine more than in 2012 and 44 more than in 2009.

The DTA have had a high focus on transfer of intangibles, inter-company financing, loss-making companies, business restructurings, permanent establishments (PEs), management fees and transactions with countries located in tax havens.

On 30 January 2015, the DTA issued an updated version of the Danish TP Guidelines (*Den juridiske vejledning* 2015-1, C.D. 11 Transfer Pricing).

Transfer pricing cases in Denmark rarely end up in litigation. There has been two significant legal cases over the past years, one concerning the disclosure of information regarding foreign companies and one concerning the determination of intercompany interest rates on deposits and borrowings in a cash pool arrangement (*discussed in detail under 'Legal cases'*).

Country	**Denmark**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes

Denmark

Country	Denmark
When must TP documentation be prepared?	At all times and no later than by the income tax return filing date[1]
Must TP documentation be prepared in the official/local language?	No (Danish, English, Swedish or Norwegian)
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	DKK 250,000 (approx. EUR 35,000) per company, per year and a minimum of 10% of an upward adjustment[2]

1. Although inter-company transactions must be documented at all times, penalties are not imposed if the TP documentation is filed within 60 days, upon request.
2. The DKK 250,000 fine may be reduced by 50% if compliant TP documentation is subsequently submitted.

Introduction

The Danish TP rules, which are based on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines, have evolved considerably since their initial implementation in the late 1990s. The Danish TP rules can be found in section 2 of the Danish Tax Assessment Act (DTAA), and section 3B and section 17 of the Danish Tax Control Act (DTCA). Section 2 of the DTAA implements the arm's-length principle and section 3B of the DTCA imposes notification requirements on the taxpayer and requires the preparation of TP documentation, while section 17 of the DTCA enacts fines and penalties for non-compliance with the documentation requirements.

In addition, the DTA issued Executive Order No. 42 in 2006 and guidelines regarding the TP documentation requirements. The latest version of the guidelines was issued on 30 January 2015 (*Den juridiske vejledning* 2015-1, C.D. 11 Transfer Pricing). The main aim is to ensure that all the requirements in the statutory rules are observed when documenting controlled transactions, truly demonstrating the adoption of the arm's-length principle.

In August 2009, the DTA introduced a valuation guideline in relation to the valuation of businesses, parts of businesses and intangible assets. The valuation guidelines are not binding for the taxpayer, but are considered the best practice for the valuation of companies and parts of companies including valuation of goodwill and other intangible assets. Further, the guidelines offer recommendations in the application of valuation models as well as recommendations to the content of documentation in relation to a valuation. The most recent update of these guidelines was on 15 January 2013.

In 2010, the DTA issued an action plan to focus on loss-making companies and companies that do not pay tax, so–called, 'zero tax' companies. In June 2012, the Danish Parliament passed a new bill on 'zero-tax' companies, tightening the rules on applicable penalties for failure to submit compliant TP documentation and authorising the DTA to, under certain conditions, impose an independent auditor's statement regarding compliance with the arm's-length principle.

Legislation and guidance

Section 2 of the DTAA provides that the arm's-length principle applies to taxpayers which:

- are controlled by an individual or company
- control companies (i.e. directly or indirectly own more than 50% of the share capital or control more than 50% of the votes in another company)
- are related to a company (i.e. are controlled by the same shareholders)
- have a PE situated abroad, or
- are a foreign individual or a foreign company with a PE in Denmark.

In this context, the term 'control' means that a company or individual owns (directly or indirectly) more than 50% of the share capital, or controls more than 50% of the votes, or has an agreement regarding controlling interest in another company. Related parties are parties that are controlled by the same (group of) shareholder(s), and the term 'controlled transactions' means commercial or financial transactions between parties, where one party either controls or is controlled by the other party or between related parties.

The arm's-length principle applies to transactions with all of the above-mentioned individuals, companies and PEs. Prior to 2005, the rules on documentation applied only to cross-border transactions, but to satisfy non-discrimination principles of European Union (EU) law, the scope was extended to also include domestic transactions. Consequently, the arm's-length principle applies to both domestic and cross-border transactions.

A foreign legal company included in a Danish joint taxation also falls under the Danish documentation requirements with respect to controlled transactions with other foreign companies or foreign individuals.

Disclosure on the tax return

In accordance with section 3B of the DTCA, Danish companies must, in addition to preparing TP documentation, complete an appendix (form no. 05.021) to their tax return, disclosing the nature and scope of transactions with related parties. Disclosure is only a requirement if the total amount of the company's controlled transactions during the income year exceeds DKK 5 million. The deadline for tax return filing for taxpayers with 31 December year-end is 30 June the following year.

Companies with related-party transactions must state for a predefined group of transactions (e.g. purchase of goods), whether the sum of inter-company transactions amount to:

- less than DKK 10 million
- between DKK 10 million and DKK 100 million, or
- more than DKK 100 million.

The company must also state whether the controlled transactions exceed 25% of the total transactions within each predefined group of transactions. In addition, one-off transactions, such as an inter-company sale of fixed assets, must also be disclosed. In addition, business restructurings must be disclosed on the tax return.

Limitations on interest deductibility

Thin capitalisation

Thin capitalisation applies to Danish companies and PEs that have inter-company debt (controlled debt) to a related company or individual, which:

- directly or indirectly owns more than 50% of the share capital, or 50% of the votes in the Danish company, and
- the debt-to-equity (D/E) ratio of the Danish company exceeds the ratio 4:1.

If these conditions are met, tax deductibility for the interest and debt losses on the controlled debt, which exceeds the D/E ratio of 4:1, is disallowed. The interest is not re-characterised as a dividend and is still treated as an interest with respect to withholding tax, etc.

If the Danish taxpayer can prove that the debt is on market terms, the deductibility is not disallowed. However, the proof will most likely be challenged by the DTA.

The term ‘controlled debt’ includes both debt directly provided by a related company and debt where a related party has provided a guarantee to a third party in order to obtain the loan.

It is worth noting that:

- the thin capitalisation rules only apply if the controlled debt exceeds DKK 10 million
- the limitation of interest deductibility only applies to the part of the controlled debt that would need to be converted into equity in order to meet the 4:1 D/E ratio
- special consolidation rules apply when assessing the assets and debt of Danish group companies, and
- the 4:1 ratio is calculated on the fair market value of the company’s assets.

Limitation on net financial expenses

Deductibility of interest expenses is limited in the following way and in the following priority:

- The above thin capitalisation rules apply.
- It is only possible to deduct net financial expenses in a Danish jointly taxed group equal to 4.2 % (2014) of the tax value of qualifying assets at year-end. However, it is always possible to deduct net financial expenses of DKK 21.3 million.

- In addition, the taxable income before interest deduction may not be reduced by more than 80% as a result of net financial expenses; however, it is always possible to deduct DKK 21.3 million in a given year. Any unused net financial expenses may be carried forward.

The corporate tax rate
The corporate tax rate in Denmark in 2015 is 23.5%. From 2016 the corporate tax rate is 22%.

Documentation

Danish transfer pricing documentation

Since 1999, documentation supporting transfer prices has been required. The documentation has to be sufficient for the tax authorities to assess whether transfer prices are consistent with the arm's-length principle.

The documentation rules can be found in section 3B of the DTCA and the specific documentation requirements are listed in Executive Order No. 42 from 2006 and the latest version of the TP guidelines issued by the DTA on 30 January 2015 (*Den juridiske vejledning* 2015-1, C.D. 11 Transfer Pricing) (Danish TP Guidelines).

Timing of transfer pricing documentation
Documentation of controlled transactions should be conducted on an ongoing basis; however, in the Danish TP Guidelines it is stated that they should be completed no later than at the time of filing the company's tax return. The deadline for tax return filing for taxpayers with 31 December year-end is 30 June the following year.

Upon request by a tax inspector, the taxpayer must submit its TP documentation within 60 days. The 60-day period is the time to dispatch the material; hence, taxpayers are advised to prepare documentation in advance of an audit. Extensions to the 60-day period are not granted by the DTA.

The aim of the Danish TP Guidelines regarding the documentation requirements is to ensure that all the requirements in the statutory rules are observed when documenting controlled transactions, truly demonstrating the adoption of the arm's-length principle.

Generally, TP documentation should be written in a report format and must include the following:

- Taxpayer's address and ID number.
- Legal and organisational structure.
- Summary of statutory financial results of the last three years (for each party to the controlled transactions).
- Description of group and Danish company including history and explanation of losses.
- Description of all controlled transactions including value.
- Description of products or services, which are transferred in the controlled transactions.
- Analysis of functions performed, risks assumed and assets employed by each party to the controlled transactions, i.e. description of value chain.
- Comparability analysis including terms and conditions of controlled transactions.
- List of inter-company agreements.

- Description of price-setting methods considered.
- Selection of the most reliable price-setting method.
- Rejection of methods not selected as most reliable.
- Description of the relevant database searches, if performed (database searches are not required, unless requested by the DTA).
- Assumptions, strategies and policies, if any, that influenced the determination of the transfer prices.

The TP documentation may be prepared in one of the following languages: English, Danish, Norwegian, or Swedish.

More than one company can be included in a single documentation report, as well as several financial years and multiple transactions can be tested and covered by the same report. However, if multiple companies or financial years are included in the same report, it is a requirement of the DTA that the report specifies for which company and for which year the specific information applies.

Small and medium sized entities
If a company is eligible for small- and medium-sized entities (SME) status, the TP documentation does not have to be completed. However, SMEs must still transact in accordance with the arm's-length principle, and are still subject to tax return disclosure. SMEs are defined by the European Commission (Recommendation 2003/361/EC) as companies with (measured at group level):

- less than 250 employees, and
- balance sheet sum of less than DKK 125 million, or
- annual turnover of less than DKK 250 million.

The exemption does not apply to inter-company transactions with affiliates and PEs in states outside the EU/European Economic Community (EEC) with which Denmark does not have a double tax treaty (DTT).

Independent auditor's statement
As of 1 January 2013, and upon request from the DTA, a taxpayer must also within 90 days submit an independent auditor's statement regarding compliance with the arm's-length principle.

The DTA can only request an independent auditor's statement on companies that have:

- inter-company transactions with residents in non-EU/European Economic Area (EEA) Member States that do not have a double tax treaty with Denmark, or
- realised a negative operating profit (earnings before interest and taxes [EBIT]) for four consecutive years on average.

Note that the request may be given retroactively, i.e. under the statute of limitation rules, and therefore the DTA may request an independent auditor's statement for the income year 2010 up until 1 May 2016.

Comparability analysis

Comparable database search

There is no compulsory requirement to prepare comparable databases searches. However, in the case of a TP audit, the DTA can explicitly require that a comparable database search using commercial databases be completed within 60 days upon request.

The comparability analysis is to provide, primarily, a basis for assessing whether the principles used by the taxpayer's group to determine prices in respect to its controlled transactions are in conformity with the arm's-length principle and secondly, the reasoning for the benchmarks used and the method chosen.

Criteria to consider for comparability analysis

The conditions concerning an inter-company transaction must be examined in order to determine whether the transaction or the company is comparable. The criteria set out in the Danish Executive Order No. 42 (issued in 2006) and the Danish TP Guidelines (latest version updated 30 January 2015) to assess comparability analysis are:

- characteristics of the products or services
- a functional analysis
- contractual terms
- economic circumstances, and
- business strategies.

In practice, the retrieval of comparable data related directly to transactions between independent companies operating under similar conditions remain infrequent as this type of direct observation implies access to detailed information that generally is confidential. Furthermore, even if the information is available, it would still be necessary for the transactions to be comparable, which also is seldom found in practice.

Conducting a sufficiently thorough comparability analysis that produces satisfactory and reliable results requires the databases used by the taxpayers to be publicly available and the data to be comparatively numerous and sufficient to build an argument, justifying that the selected independent companies are comparable with the tested company. Practical experiences show that no two transactions are identical. It is, therefore, necessary for the taxpayers to examine the results thoroughly on whether the differences found are significant enough to affect the comparability of the selected independent companies.

Elements of the comparability analysis write-up

In addition to the preparation of the comparability analysis, the comparability analysis must be described as part of the TP documentation. The descriptions must contain the following four elements:

- Identification of the tested transaction(s) and the pricing methods.
- Detailed written descriptions of the comparability searches providing the arguments and reasons for the qualitative and quantitative search steps.
- Explanation of the justification and range.
- Materials for the documentation from the database.

Although the Danish TP Guidelines provide an example of the presentation of the elements described above, it is stated that taxpayers may prepare the descriptions of their comparability analysis differently, as long as the elements above are taken into account and references to section 10 of the Executive Order No. 42 (2006) are provided thoroughly.

The TP methods listed in the Danish legislation are in line with the OECD Guidelines. The most reliable method to evaluate an inter-company transaction must be selected and applied. When the transactional net margin method (TNMM) is applied, the least complex company to the inter-company transaction under review (i.e. not necessarily the Danish company) should be the tested party.

Regional comparable searches (i.e. pan-European benchmarks) are accepted, but local comparable companies are preferred (e.g. Eastern European companies may be disqualified for not being comparable within certain industries).

Quantitative and qualitative search steps
According to the Danish TP Guidelines, the following search criteria are suggested, but not compulsory, to be included in a comparability search process:

- Identify the activity of the tested company: branch code(s), keywords related to the industry, key accounting data.
- Identify the economic circumstances: geographic boundary, size of the tested company's activity, number of years with activity.
- Identify the key accounting data to justify the pricing and qualification of the arm's-length principle.
- Verify the data available through additional qualitative steps through: internet, websites of companies and other possible methods.

It is pointed out that the selection of comparable companies must, nonetheless, be consistent. This section of the Danish TP Guidelines implies the need to avoid any cherry-picking of profitable companies among the independent companies available as comparable by both the taxpayers, when preparing a comparability analysis, and by the tax authorities during tax audits.

Like many European countries that use the OECD Guidelines as the model for the local TP guidelines, Denmark recognises the use of average data of the past few years for the purpose of comparability analysis. Furthermore, the range of data available for multiple years might disclose facts that may have influenced the determination of the transfer prices. Companies relying on comparables, i.e. benchmark studies, are advised to update these on a regular basis. How often, depends on the industry and if there has been a major change that has affected the market.

In Denmark, the use of an arm's-length range is not explicitly specified in the legislation, but it is common practice for the data from the database to be measured using the median as the statistical tool to determine the representative result of a sample set. The interquartile range is also used to determine the range of acceptable transfer prices. An interquartile range is advantageous, because by excluding outlying or extreme data point, which may be unrepresentative, the range frequently provides a good indication of representative values.

Penalties

Penalties for non-fulfilment

Penalties apply if a company does not submit compliant TP documentation within 60 days of a request from the DTA. Section 17 of the DTCA provides that penalties may be imposed if TP documentation has not been prepared.

From a practical perspective, the penalties regime has been tightened in 2012 and applies if the TP documentation does not exist or if the documentation is deemed inadequate. Two-tier penalties apply to the following:

- Failure to submit compliant TP documentation within 60 days of request from the DTA, or failure to submit an independent auditor's statement may result in a fixed penalty of DKK 250,000 (approximately EUR 35,000) per company, per year. The DKK 250,000 fine can be reduced by 50% if compliant TP documentation is subsequently submitted.
- In addition to the lack of documentation or inadequate documentation, if an income adjustment is issued (i.e. the arm's-length principle has not been observed), the minimum penalty may be increased with an amount of 10% of an upward adjustment.

The above penalties apply to income years not barred by the statute of limitations, i.e. income year 2010 may be subject to penalties until 1 May 2016.

Further, section 14 of the DTCA provides that penalties apply if a company files incorrect or misleading information on its tax return, which includes information provided on the appendix (form no. 05.021) regarding transactions with related parties. The size of the penalty is calculated with reference to either the number of employees in the company or the revenue, whichever results in a higher sum:

- Failure to submit correct information in the tax return may result in a fixed penalty of DKK 250,000 if up to 50 employees. The fine is increased by DKK 250,000 for every additional 50 employees in the company. If the company has more than 500 employees the fine is limited to DKK 2 million, or
- The fine is set on the basis of the company's revenue. The fine may result in a fixed penalty of 0.5% of the company's revenue up DKK 500 million, and 0.1% of the residual revenue up to DKK 1 billion and DKK 0.05% of the company's revenue above DKK 1 billion.
- The fine for incorrect or misleading disclosure may be increased by 50% if the incorrect or misleading disclosure is committed as part of a systematic breach of the law.

The DTA may impose the above penalties, i.e. if compliant TP documentation is not filed in due time or the appendix (form no. 05.021) to the tax return contains incorrect information, up to 5 years after the time of the breach, i.e. from the final submission deadline of the TP documentation or tax return.

Statute of limitations on transfer pricing adjustments

As a general rule, the DTA is not allowed to reopen a tax assessment, detrimental to the taxpayer, later than the end of April in the fourth year after the income year has expired.

This general time limit is extended by two years in respect of TP adjustments. For TP, the DTA may issue a notice of an adjustment no later than 1 May in the sixth year following the income year-end (e.g. notice of adjustment for the income year 2010 must be made no later than 1 May 2016). The final adjustment must be issued no later than 1 August, and also in the sixth year following the income year-end.

Surcharge and interests on upward adjustments
Following an upward adjustment of taxable income, the taxpayer is subject to a surcharge and interest on the adjustment, i.e. tax payable.

First, a surcharge is added to the adjusted taxable amount. This is a one-time charge calculated on the tax payable and is based on a percentage set by the Danish Minister of Taxation for the given year that the upward adjustment relates to.

Second, an interest rate will be levied on the tax payable (including the surcharge). The interest accrues monthly from 1 November (for the calendar year-end taxpayer) after the financial year in question until the date of payment of the additional tax, e.g. if an upward tax adjustment is imposed on the income year 2010, the surcharge percentage from 2010 (5.1%) will apply and the monthly interest will accrue from 1 November 2011.

	Surcharge	Interest rate
2010	5.1%	0.5%
2011	4.8%	0.5%
2012	4.3%	0.5%
2013 (1/1-31/7)	3.9%	0.4%
2013 (1/8-31/12)	3.9%	0.7%
2014	4.6%	0.8%
2015	4.5%	0.8%

Transfer pricing controversy and dispute resolution

Tax audits

In general, the DTA are allowed to request any information of relevance for the tax assessment and have the authority to make an estimated adjustment of the taxable income if information is not provided. In addition, the conduct of the taxpayer during an audit may influence the outcome because a refusal to provide documentation can reduce or even reverse the burden of proof of the DTA. While it is possible to negotiate with the DTA before the adjustment is finalised, it is not likely that the outcome of the audit will be a result of either negotiation or litigation, but rather an assessment raised by the DTA, based on its audit findings.

Selection of companies for tax audits

Transfer pricing continues to be an audit theme and with the continued focus on TP, the DTA frequently audit the transfer prices of companies resident in Denmark. If a Danish company is part of a multinational group, the DTA will generally always issue a request for the TP documentation in a tax audit.

In addition, the DTA's current focus is multinationals that have loss-making operations in Denmark, or have an apparent lack of taxes paid to Denmark ('zero tax' companies).

Companies with the following characteristics can expect to face increased risk of extensive TP audits in Denmark during 2015:

- Continuous losses, i.e. zero tax.
- Business restructurings and/or intellectual property (IP) transfers.
- Related parties in non-treaty countries.
- Operates a branch in Denmark.
- Companies operating under the Danish Tonnage Tax Act.
- Part of one of the largest 150 international groups operating in Denmark.
- Companies engaged in business in the oil industry under the Danish Hydrocarbon Tax Act.
- Companies making payments in connection with an inter-company captive/ reinsurance programme.
- Companies relying on inter-company financing.

Risk transactions or industries
It is not possible to generally identify specific transactions or industries where TP adjustments are more likely than others. Transfer pricing adjustments are often not appealed and therefore not published. More straightforward cases such as management fees are still taken up during tax audits. However, the tax authorities in Denmark have become more experienced in TP matters and are not reluctant to engage in more complicated TP issues. Moreover, another trend often seen is that the DTA attempt to disregard the business model chosen by the taxpayer, e.g. by reclassifying for example a fully-fledged sales entity to be a service provider. Resources continue to be dedicated to the TP area.

Simultaneous examinations
Denmark will cooperate with other countries in undertaking simultaneous examinations of multinational groups. Indeed, this has already been practised within the Nordic countries, and it is conceivable that it will occur with respect to other countries as well.

Appeals' procedure
A TP adjustment imposed by the DTA must in the first instance be appealed at the administrative level to the Danish National Tax Tribunal, after which it is possible to continue the appeal to the courts. The first instance within the court system is the district court, or for principal cases, High Court and ultimately, the Supreme Court.

Burden of proof
Taxpayers are under a legal obligation to maintain current TP documentation. To the extent that this requirement is not met, the burden of proof may be reversed to the taxpayer.

In two of the most significant court cases regarding TP (Texaco and BP), the courts confirmed that the burden of proof lies with the DTA, but the taxpayer is required to disclose information relevant to the question of whether the arm's-length principle has been violated. This information would include items such as prices and profit earned by the parent company when dealing with other group companies and with unrelated customers. Where this information is not disclosed, the court concludes that the burden of proof on the DTA is reduced.

The DTA may estimate TP adjustments if the TP documentation is inadequate. This represents a significant shift in the balance of the burden of proof between the tax authorities and taxpayers. Furthermore, the conduct of the taxpayer during the investigation may influence the outcome because a refusal to provide documentation can reduce or even reverse the burden of proof of the DTA.

Legal cases

Transfer pricing disputes are rarely taken to court as most disputes are solved through compromise. There have been five significant cases on TP. The first two were the so-called 'oil cases', both from the late 1980s, the third, Swiss Re, regarding the statute of limitations was tried in 2012. In 2014, there were two legal cases, one concerning the disclosure of information regarding foreign companies and one concerning the determination of intercompany interest rates on deposits and borrowings in a cash pool arrangement.

Burden of proof

The oil cases involving BP and Texaco were the first TP cases to be tried in Denmark. Both decisions were on the question of burden of proof and ruled in favour of the taxpayers. In the Texaco case, the court found that the taxpayer could be required to disclose information regarding prices and gross profit. This information was, however, not available to Texaco Denmark and by that not available to the DTA. The High Court ruled that, despite this lack of information, a comparison of prices with the Rotterdam spot market suggested that they did not differ significantly and an adjustment could therefore not be justified.

The BP case built upon the Texaco case. A price analysis suggested that prices paid by BP Denmark were 9% higher than the Rotterdam spot market; therefore, the High Court found a minor increase in BP's taxable income justified. This decision was taken to the Supreme Court. The Supreme Court repeated that the burden of proof rested on the DTA, but that a taxpayer's failure or refusal to disclose evidence would reduce this burden. The conclusion reached by the Supreme Court was that as BP Denmark dealt on long-term contracts, a difference in the pricing could be caused by the contractual set-up. The DTA had failed to show that the difference in price was a result of BP Denmark being a controlled company and not a result of the contractual terms, and the Supreme Court ruled in favour of BP Denmark.

Disclosure of information

In a recent case from 2014, the Danish National Tax Tribunal considered whether a company was required to comply with the DTA's order to disclose information regarding its foreign companies.

The DTA had ordered the company to provide information in the form of financial statements of its two foreign subsidiaries and tax specifications of one foreign subsidiary, as well as documentation of a transfer of inventory between two foreign subsidiaries.

The Tribunal focused on the word 'its' in section 6 of the DTCA in relation to accounting records and other documents, and pointed out that there is no statutory ground to require disclosure of information other than the company's own accounting records and documents. The Tribunal noted that the law does not provide more stringent disclosure requirements, purely based on the fact that parties are related. The Tribunal reached the conclusion that the law did not provide a right for the DTA

to impose an obligation for the company to provide materials for its other foreign companies and the company did not have to disclose the information of its other foreign subsidiaries other than its own.

Statute of limitations
A judgment from the Supreme Court from 2012 expands the scope of section 2 of the DTAA to not only include pricing and terms, but also the legal qualification of a transaction.

The case concerned the DTA's adjustment of a loan agreement between a Danish company and a US holding company. The parties did not agree on the payment terms until three and a half months after they entered into the loan agreement. Therefore, the DTA fixed the interest rate for the first three and a half months and disregarded the parties' agreement to remunerate in the form of capital gains. The tax adjustment took place in the 5th and the 6th year after the two taxable income years in question. The Danish National Tax Tribunal rejected the DTA's adjustment, due to the fact that the statute of limitations (four years) barred an adjustment.

The Ministry of Taxation took the case to the High Court, which rejected the decision made by the Danish National Tax Tribunal.

Subsequently, the Supreme Court upheld the High Court's judgment by confirming that the extended statute of limitations, i.e. six years, applies to any adjustments related to inter-company transactions. The adjustment was therefore made by the DTA within the time limit. Furthermore, the Supreme Court pointed out that the possibility for TP adjustments applies to all economic issues and other conditions related to taxability (e.g. time of payment, accruals of interests, capital losses and the legal qualification of a transaction.)

Cash Pool Arrangement
In early 2014, the National Tax Tribunal published its first transfer pricing decision regarding a cash pool arrangement. The decision concerns the determination of intercompany interest rates on deposits and borrowings in the cash pool.

The National Tax Tribunal found that the Danish tax authorities were allowed to disregard the TP applied by the company due to inadequate TP documentation. Furthermore, the National Tax Tribunal concluded that the Danish company's deposits in the cash pool arrangement should be considered as loans to the cash pool administrator, and that the interest rate would have to be set accordingly based on a credit rating of the borrower.

Limitation of double taxation and competent authority proceedings
The DTA is, without any limitations in time, obliged to reopen a tax assessment on request by a taxpayer, if there has been a TP adjustment abroad.

It should be noted, however, that the DTA is always entitled to form its own opinion on the TP issue in question. The authorities may disagree with an adjustment made by a foreign tax authority and consequently refuse to make a corresponding adjustment.

A Danish taxpayer can avoid a secondary adjustment if prices and terms are adjusted in accordance with a TP adjustment.

Denmark

The Danish competent authority on TP matters is the central TP unit within the DTA. Danish administrative principles, while not permitting the mutual agreement procedure to become a process of litigation, grant the taxpayer the right to comment on, and discuss the position taken by, the authorities. If a corresponding adjustment is refused by the authorities, it is possible to appeal to the courts.

Transfer pricing disputes with the EU can be resolved in accordance with the Convention on the elimination of double taxation in connection with the adjustments of profits of associated enterprises (Convention of 23 July 1990, 90/436/EEC), which became effective in 2006.

Year-end and retroactive adjustments

Year-end and retroactive adjustments and true-ups require special attention in Denmark. They should preferably be used as a method of last resort and need to be supported by the underlying inter-company legal agreements or TP policies. Furthermore, consideration should be given to legal, accounting, VAT and customs' issues, depending on the type of adjustment.

Advance pricing agreements (APA) and binding rulings

It is possible to apply for bilateral APAs with countries with which Denmark has DTTs, by reference to the mutual agreement article. Although Denmark does not have an official APA programme, APA applications are accepted and negotiated. The first bilateral APA involving Denmark was concluded in 2002, and since then numerous bilateral APA agreements have been concluded with Denmark. The number of bilateral APA requests has increased significantly during the last five years. Denmark was the first European country to conclude a bilateral APA with China.

The DTA are planning to issue Danish APA guidelines. However, these guidelines have been under way since 2008 and it remains uncertain when the final guidelines will be released. These guidelines will largely follow the recommendations from the Joint Transfer Pricing Forum under the EU Commission, issued on 26 February 2007.

It is not common for the DTA to process unilateral APAs. However, taxpayers have the possibility of applying for a binding ruling concerning the tax treatment of a given transaction. Binding rulings will be provided by the Danish Tax Assessment Committee, and the response will typically be provided within three months. However, if upon request for a binding ruling, it is found that insufficient documentation has been submitted in order to provide a response, or if the request is complicated, the authorities may extend its response time or reject the response.

Comparison with the OECD Guidelines

Denmark is a member of the OECD and applies their interpretation of the OECD Guidelines.

31.

Dominican Republic

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Overview

On 9 November 2012, the Dominican Government enacted the Tax Reform Law No. 253-12, which modifies Article 281 of the Dominican Tax Code (DTC). The Tax Reform Law No. 253-12 expands the scope established in General Rule 04-2011, stating that inter-company transactions between resident entities, regardless of whether such are foreign-owned or not, or with entities located in low-tax jurisdictions, must be carried out in accordance with the prices agreed in the transfer of goods or services between independent parties (arm's-length principle). This scope is effective for fiscal years beginning 1 January 2013.

Country	**Dominican Republic**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Before annual income tax return is due
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	0.25% of gross revenues of the prior fiscal year

Dominican Republic

Introduction

The arm's-length principle was first introduced in Article 281 of the DTC enacted in 1992, which established that legal acts between a local enterprise of foreign capital and an individual or legal entity domiciled abroad, which directly or indirectly controls the other, shall be considered to be, in principle, carried out between independent parties.

However, Law 495-06, enacted in December 2006, introduced the methodology to evaluate inter-company transactions and granted the Dominican tax authorities (DTA) the faculty to challenge the prices agreed between related parties when they are not consistent to those that should have been paid by independent third parties in similar circumstances.

Law 495-06 also empowered the DTA to subscribe advanced pricing agreements (APA) with taxpayers pertaining to the all-inclusive hotel industry, which are represented by the Dominican Republic National Hotel & Restaurant Association. The APAs incorporate prices based on a standard parameter by zones, cost analysis and other variables that impact the tourism industry. These APAs are valid for 18 months and, once renewed, they may remain in force for up to 36 months. APAs may also be obtained in other industries with foreign involvement, such as the pharmaceutical, power and insurance sectors.

In 2011, the DTA issued General Rule 04-2011, establishing specific documentation requirements and further regulations on the transfer pricing (TP) dispositions included in Law No. 495-06. General rule 04-2011 establishes that inter-company transactions include those that take place with foreign-related parties, as well as any transactions with entities in tax havens or operating in free trade zones. The said General Rule establishes that even if there is no ownership, an exclusive relationship may be considered to be related parties. The General Rule 04-2011 generally adheres to the arm's-length principle and is aligned with guidelines issued by the Organization of Economic Co-operation and Development (OECD), referred as the OECD Guidelines.

Law 253-12 includes the possibility of requesting APAs to the DTA for all taxpayers, not only for the all-inclusive hotel industry as stated in Law 495-06, in which according to Law 253-12, it does not require the intervention of the Dominican Republic National Hotel & Restaurant Association in order to request an APA.

Legislation and guidance

Article 281 of the DTC enacted in 1992, established that legal acts between a local enterprise of foreign capital and a natural person or legal entity domiciled abroad, which directly or indirectly controls the other, shall be considered to be, in principle, carried out between independent parties when their provisions adhere to normal market practices between independent entities.

In 2011, the DTA issued General Rule 04-2011, establishing specific documentation requirements and expanded TP dispositions of Law No. 495-06. This provision only applies to local enterprises of foreign capital.

The aforementioned Tax Reform Law No. 253-12 states that related-party transactions carried out between resident entities, regardless of whether these are foreign-owned or not, or with entities resident in low-tax jurisdictions or tax havens, must be carried

out in accordance with the prices agreed in the transfer of goods or services between independent parties.

The foregoing provisions shall also apply where a resident engaged in commercial or financial transactions with:

- a related resident entity, or
- individuals or legal entities domiciled, incorporated or located in territories with preferential tax regimes, low-tax jurisdictions or tax havens, whether or not the latter are related. The latter is considered to be related for the purposes of this Law.

Also, the Law establishes that even if there is no ownership, an exclusive relationship, favourable conditions in the transaction, or a permanent establishment, it may be considered that the parties are acting as related ones.

When the prices agreed by commercial or financial transactions between entities subject to this article, fail to conform to the values that are charged for similar transactions between independent enterprises, the DTA may challenge such and carry out appropriate adjustments when valuation agreed between the parties would result in a lower tax in the country or deferred taxation.

To determine the price or amount of transactions between related parties, the DTA will compare the prices agreed in transactions between related entities with those between independent parties. The following factors were considered to the extent that it is economically relevant:

- The characteristics of the good or service.
- The functions performed, assets used and considering the risks involved in operations of each of the parties involved in the transaction.
- The contractual terms of the transactions.
- Economic circumstances
- Business strategies.

For purposes of determining the arm's-length price of transactions between related parties, any of the following methods shall be used:

- Comparable uncontrolled price method (CUP)
- Resale price method (RPM)
- Cost plus method (CP)
- Profit split method (PSM)
- Transactional net margin method (TNMM)

If any of the first three methods cannot be properly applied due to the complexity of operations or lack of information, then the latter two methods will apply.

In the case of imported goods, traded on transparent markets, the CUP method would apply between independent parties, considering that for tax purposes, the market price of the goods in the transparent market is the one reflected on the date of Custom's clearance, disregarding the type of transportation used. In the case of export goods, the price will be the market price of the goods in the transparent market on the first day of loading the goods.

The same method applies when exports are made without a non-related intermediary (which is not the effective recipient of the merchandise) and if the taxpayer cannot prove, according to the current legislation on the matter, having real and effective presence in their country of residence or dedicated to the intermediation activity.

In the case of service transactions between related parties, the compensation for such services shall be considered in accordance with normal market prices between unrelated parties, if:

- the service was effectively provided
- the service rendered provides an economic or commercial benefit to whoever receives it, and
- the amount of value agreed, corresponds to the amount that would be agreed to between independent enterprises in comparable services.

The Law provides the possibility of taxpayers requesting an APA that sets the values of the transactions carried out between related parties, if made prior to completion. The taxpayer shall make this request to the DTA with a proposal based on the value that would have been agreed between independent parties in similar transactions.

The APA's proposal may be approved, denied or modified by the DTA. The resolution that rejects or modifies the proposal may not be appealed. If the proposal is amended, the taxpayer is not obliged to sign it.

Upon signature, the APA will become effective for the fiscal year in course and for three subsequent fiscal years. It also applies to fiscal periods that expired from the date of submission until the subscription, with the limit of two years counted from that date.

The DTA may challenge the taxpayers' declared values included within the APA when these do not correspond to the criteria agreed to in the APA and therefore apply the penalties established in the DTC.

For certain sectors or economic activities, the DTA may determine a minimum price or profit margin. If the taxpayer accepts this price or profit margin and reflects this in its income tax returns, the DTA shall consider that it has been agreed between independent parties in comparable transactions and under the same or similar circumstances. The price or minimum tax profit margin may be calculated, taking into account the total income, the assets used in the business operations during the fiscal year, the total amount of costs and expenses and/or other sector variables.

Penalties

Failure to comply with the filing of the TP informative return will result in the following penalties: payment of 5 to 30 national minimum wages and 0.25% of the gross revenues declared on prior fiscal year.

Failure to comply with the provisions relating to the TP documentation (false or incomplete data), the taxpayer incurs a violation of formal duties and shall be liable to the payment of up to triple the amount of the penalties described in the paragraph above.

If the taxpayer does not comply with the TP documentation requirements and the DTA confirms an adjustment, it is considered tax evasion and consequently subject to the penalty payment of up to two times the amount of tax omitted. In addition to the tax due and penalties, the DTA may close down the business.

Documentation

At the time of filing the income tax return, taxpayers should have all the information and sufficient analysis to demonstrate that its operations with related parties comply with arm's-length principle, according to Article 281. Although, the Dominican tax law does not establish a specific deadline to file the contemporaneous documentation, it must be available upon request by the DTA.

Dominican taxpayers are required to file an informative return for related transactions within the next 60 calendar days after the income tax return is filed.

Transfer pricing controversy and dispute resolution

The statute of limitations for TP obligations according to Dominican tax law is three years in case the informative TP return is filed and five years in case the tax return is not filed. The burden of proof lies with the taxpayer to demonstrate that the transactions between related parties comply with arm's-length principle.

Article 281 of Dominican tax law establishes the possibility to subscribe APAs. After a long process of controversies and disputes, the DTA and the Dominican Republic National Hotel & Restaurant Association (ASONAHORES, for its acronym in Spanish) signed an APA that establishes the general framework for entities that provide all-inclusive services in the sector to establish their individual APAs. The agreement establishes the prices from which the tax on VAT and income would be calculated for fiscal years 2013 through 2015. The agreement also establishes the TP method that would be used to analyse the all-inclusive transactions conducted with related parties abroad.

Comparison with OECD Guidelines

Dominican Republic is not a member of the OECD; nonetheless, TP regulations adhere to OECD Guidelines.

Dominican Republic

32. Ecuador

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Overview

In January 2013, through a tax ruling, the Ecuadorean tax authorities modified transfer pricing (TP) legislation to establish the obligation for taxpayers to include details of transactions with local related parties in the corresponding TP report. Previously, only cross-border taxations needed to be disclosed. Therefore, this amendment applied to TP reports for the year ended 31 December 2012 and onwards.

Additionally, this tax ruling modified the TP thresholds used to determine the level of documentation the taxpayer would have to present regarding their transactions with related parties. The most significant change in this regard is that taxpayers who have transactions with related parties amounting to less than 3 million United States dollars (USD) are no longer required to file the TP documentation with the Ecuadorean Internal Revenue Service (*Servicio de Rentas Internas [SRI]*), where previously the threshold was USD 1 million. Notwithstanding, please note that while there is no obligation to file the documentation, the SRI may request this documentation in their audit activities.

Country	**Ecuador**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No

Ecuador

Country	Ecuador
When must TP documentation be prepared?	Taxpayers undertaking transactions with related parties for cumulative amounts greater than USD 3 million within the same financial year must file a TP annex within two months from the corresponding filing date of their income tax return. Taxpayers undertaking operations with related parties for cumulative amounts greater than USD 6 million within a same financial year must file, in addition to the TP annex, a comprehensive TP report within two months after the corresponding filing date of their income tax return.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Failure to file the TP annex or the comprehensive TP report on the established dates can result in a fine up to USD 15,000. The same fine may apply to cases where the information presented in the annex and the report is incorrect or differs from the information provided in the taxpayer's Corporate Income Tax (CIT) return.

Introduction

Ecuadorean TP rules apply to taxpayers undertaking local and cross-border operations from fiscal year 2005 onwards. The local regulations expressly recognise the Guidelines established by the Organisation for Economic Co-operation and Development (OECD) as a technical reference in TP matters.

Legislation and guidance

Statutory rules

Ecuadorean taxpayers should be able to demonstrate that their transactions with related parties are conducted in accordance with the arm's-length principle. Transfer pricing rules are applicable to all types of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions, reimbursement of expenses and licensing of intangible property). Transfer pricing rules apply to local and cross-border transactions with related parties in the following manner:

Taxpayers undertaking transactions with related parties for cumulative amounts greater than USD 3 million within the same financial year must file a TP annex within two months from the corresponding filing date of their CIT return.

Taxpayers undertaking operations with related parties for cumulative amounts greater than USD 6 million within the same financial year must file, in addition to the TP annex, a comprehensive TP report within two months after the corresponding filing date of their CIT return.

Any adjustments arising from the application of TP regulations must be included in the tax return and will affect the taxpayer's taxable income.

Related parties

'Related parties' are defined as individuals or entities in which one party directly or indirectly participates in the direction, control or capital of the other, or in which a third party, individual or entity participates in the direction, control or capital of the others.

In order to establish if there is any relationship among the entities, the tax administration will consider, in general terms, the participation in the companies' shares or capital (more than 25%), the holders of the capital, the entity's administration, the distribution of dividends, the proportion of transactions carried out between entities (more than 50% of total sales, or purchases, among others, provided that the tax authority notifies the taxpayer, and it may demonstrate that there is no relationship to management, administration, control or capital) and the pricing mechanisms used in such operations. Specifically, the regulations list the following situations as related parties:

- Head offices and their subsidiaries, affiliates and permanent establishments (PEs).
- Subsidiaries, affiliates and PEs among themselves.
- The parties in which one individual or company share directly or indirectly in the direction, administration, control or capital of such parties.
- The parties that maintain common directive bodies with a majority of the same members.
- The parties in which the same group of members, partners or shareholders participate directly or indirectly in the direction, administration, control or capital of such parties.
- The members of the directive bodies of the entity with respect to the entity, as long as the relationships between them are different to those inherent to their positions.
- The administrator and statutory auditors of the entity with respect to the entity, as long as the relationships among them are different to those inherent to their positions.
- The entity with respect to the spouses and relatives (fourth degree of consanguinity and second degree of affinity) of the directing shareholders, administrators and statutory auditors.
- The entity or individual with respect to the trusts in which it has rights.

The Ecuadorean law also deems transactions as being carried out by related parties when such transactions are not carried out at 'arm's length' or, when they take place with individuals or entities located in tax haven countries or jurisdictions.

Currently, the tax authority has updated the list of tax havens, in which it includes and excludes some countries previously categorised as tax havens. It is worth noting that the tax havens list is updated as deemed necessary by the Ecuadorean tax authorities.

Comparability
Operations are deemed comparable if no differences exist between their relevant economic characteristics that significantly affect the price or value of the goods and services, or the 'arm's-length' margin, or, in instances where these differences exist, they can be eliminated through reasonable technical adjustments.

In order to verify whether the operations are comparable, or if there are significant differences between them, the following factors should be considered when assessing the comparability of a transaction:

- The specific characteristics of the goods or services.
- The functions that each taxpayer performs including the assets used and the risks undertaken.
- The terms and conditions (contractual or not) that exist between related and unrelated parties.
- The economic circumstances of different markets, such as geographical location, market size, wholesale or retail, level of competition, among others.
- Business strategies including those related to market penetration, permanence and expansion.

Methods
According to TP regulations, the following methods should be used when assessing the arm's-length principle in transactions with related parties:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost-plus method (CPM).
- Profit split method (PSM).
- Residual profit split method (RPSM).
- Transactional net margin method (TNMM).

Ecuador's TP regulations contain a best method rule. They also indicate that the methods must be applied hierarchically starting with the CUP method through to the TNMM, along with an explanation of why each method has been discarded. Transfer pricing regulations state that the application of the methods should be interpreted in accordance with OECD Guidelines in so far as [the guidelines] do not contradict local legislation.

Transfer pricing regulations include the use of the interquartile range and the adjustment to the median if the taxpayer's result falls outside the range.

Other regulations
The SRI enacted rulings to establish the content required in the TP annex and the integral TP report.

Joint investigations
Transfer pricing regulations do not establish specific procedures for joint investigations.

Thin capitalisation
As of 1 January 2008, thin capitalisation provisions must be considered by taxpayers. In effect, if the amount of a foreign loan exceeds three times the amount of the paid capital, the interest expense will not be considered as a deductible expense for corporate income tax calculation purposes.

Indirect Costs
Indirect expenses allocated to enterprises domiciled in Ecuador by their related parties cannot exceed 5% of the CIT taxable base.

Royalties, technical, administrative and consulting
Through tax reforms in force as at 1 January 2015, rules where implemented which established that the sum of royalties, technical services, administrative, consulting and similar paid by resident companies or PEs in Ecuador to related parties (foreign or local) may not exceed 20% of CIT tax base.

Penalties
Failure to file the TP annex or the comprehensive TP report on the established dates can result in a fine up to USD 15,000. The same fine may apply to cases where the information presented in the annex and the report is incorrect or differs from the information provided in the CIT return.

Documentation
Transfer pricing annex
As previously stated, taxpayers exceeding the materiality threshold on operations carried out with related parties during the fiscal year must present a TP annex (technically known as 'Annex OPR'). The annex must include:

- Taxpayer's information including the Taxpayer Identification Number ('RUC' for its acronym in Spanish) and duly identify the fiscal year it relates to.
- Identification of related parties including name, address, fiscal residence and taxpayer identification number in the country of fiscal residence.
- Details of transactions with related parties including type of operation, monetary amount of the operation, and method used to determine compliance with the arm's-length principle.
- The margin obtained by the taxpayer on each type of transaction.
- Transfer pricing adjustment amount (if applicable).

Transfer pricing report
In accordance to local regulations, the TP report should include the following information:

- The background and functions performed by the group the taxpayer belongs to.
- The background, functions performed, risks borne and assets used by the taxpayer on its business.
- An explanation of the elements, documentation, facts and circumstances taken into account and valued for the TP analysis or study.
- Details and amounts of the inter-company transactions, subject to analysis.
- Details of the related entities with which the company carried out the transactions subject to analysis.

- A macroeconomic context, global and local analysis of the industry in which the taxpayer operates.
- Detail and quantification of operations carried out with related parties.
- Selection of the most appropriate method, with an explanation of the reasons why it was considered the method that best reflected the arm's-length principle.
- Selection of the profitability indicator in accordance with the selected method.
- Detail of the search process performed on the respective databases in order to obtain a set of comparables for the analysis. Such detail should include each of the search screens used, which correspond to each of the steps sequentially followed from the beginning of the process to the comparables selection for the TP analysis. Additionally, a detail of comparables must be attached for the application of the method used.
- Detail of the elements, quantification and methodology used for the adjustments of the selected comparables.
- Detail of the comparables that were not selected, indicating the reasons for the rejection.
- Detail of the comparable companies' activity and business characteristics.
- Determination and quantification of the median and the arm's-length range.
- Financial status and results of comparable companies corresponding to the fiscal years necessary for the comparability analysis including the source of such information.
- Conclusions.

Transfer pricing controversy and dispute resolution

Legal cases

Transfer pricing rules were introduced as part of the Organic Internal Tax Regime Law ('LORTI' for its acronym in Spanish) in January 2008. At the moment there are TP cases at the tax court level. However, no significant tax court rulings have been issued in this regard.

Burden of proof

In practice, the burden of proof lies with the taxpayer for filing the TP annex and the TP report.

Tax audit procedures

At the moment, there are no TP specific tax audit procedures. Transfer pricing obligations are audited as part of regular income-tax audits conducted by the SRI.

Tax audit-related inspections are carried out first as desk reviews, based on detailed information provided by the taxpayers and, subsequently, at the taxpayer's office. Taxpayers must make available all basic accounting records, auxiliary records, as well as all sources of information supporting the financial statements, the tax returns and the TP annex and report.

Once the tax audit has been completed, inspectors prepare an assessment that either confirms the declared taxable income and the tax paid, or requests payment of additional taxes arising from the objections resulting from the audit. Among these objections, the administration could challenge the adequacy of the TP study and establish different TP adjustments for income tax purposes.

Revised assessments and the appeals' procedure
Taxpayers have the right to file objections with the SRI against additional tax assessments arising from tax audits within 20 days of receipt of the notification of assessment. The SRI must issue its ruling within 120 days of the appeal. The lack of response of the SRI within 120 days is considered a tacit acceptance of the claim presented by the taxpayer.

If the appeal to the SRI is unsuccessful, the taxpayer can appeal before the Fiscal Court, which is organised into several chambers of three judges each. Each chamber processes claims and issues judgments independently from the others. In the event that taxpayers do not agree with the judgment made by a particular chamber of the Court, they have the right to appeal before the entire Court (i.e. all three chambers). Only legal issues are discussed before the full Court.

Resources available to the tax authorities
There is a unit within the SRI that deals specifically with TP issues.

Use and availability of comparable information
Comparable information is required in order to determine arm's-length prices and should be included in the taxpayer's TP documentation. Ecuadorean companies are required to make their annual accounts publicly available by filing a copy with the local authority, e.g. the Superintendence of Companies. However, these accounts do not necessarily provide enough or sufficient information on potentially comparable transactions since they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign comparables. This practice would be acceptable under Ecuadorean TP regulations.

Limitation of double taxation and competent authority proceedings
Domestic TP legislation is supplemented by the provisions of the double taxation treaties that Ecuador has signed with several countries (Brazil, Belgium, Chile, China, France, Germany, Italy, Romania, Spain, Canada, Mexico, South Korea, Switzerland, Uruguay, and the nations of the Andean Community: Colombia, Peru and Bolivia). Additionally, Ecuador is at the moment negotiating double taxation agreements with Qatar and the United Arab Emirates. These agreements generally include provisions on mutual agreement procedures, related parties and business profits.

Advance pricing agreements (APAs)
Ecuadorean legislation does establish the possibility of APAs.

Anticipated developments in law and practice
Law
According to changes in tax legislation in force since 1 January 2010, taxpayers are excluded from applying TP rules if they comply with the following:

Income tax due is higher than 3% of taxable income.

There are no transactions with tax havens or low-tax jurisdictions.

There is no contract in place with the Government for the exploitation of non-renewable resources.

CIT taxpayers who have undertaken transactions with related parties and which are exempt from the application of the TP compliance requirements, must submit to the tax authorities within a period not exceeding one month from the date of the deadline set for the submission of the CIT return, a summary of specific information in accordance with the corresponding provision and regulations stated within the law.

Practice

It is expected that tax authorities will become more skilled and aggressive in handling TP issues. Transfer pricing knowledge of tax inspectors is expected to increase significantly, as training improves and they gain experience in TP audits.

Liaison with customs' authorities

Tax authorities and customs' authorities may exchange information. Experience suggests that the authorities do not deal very closely with each other where transfer prices are concerned.

Comparison with OECD Guidelines

OECD issues

Ecuador is not part of the OECD, but according to TP rules, the OECD's TP Guidelines for Multinational Enterprises and Tax Administrations are used as a technical reference for TP purposes.

33.

Egypt

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Overview

The Egyptian Transfer Pricing Guidelines, which are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines, define the arm's-length principle, related parties and the transfer pricing (TP) methods together with the priority in which such methods should be applied. Transfer pricing provisions are applicable to international and domestic transactions between related parties.

Country	**Egypt**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Contemporaneously, upon the occurrence of transactions.
Must TP documentation be prepared in the official/local language?	No
Are related party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	Penalties are determined based on the percentage of the excluded tax amount.

Egypt

Introduction

In November 2010, the Egyptian Tax Authority (ETA) released its Egyptian Transfer Pricing Guidelines. The Egyptian Transfer Pricing Guidelines, consistent with the OECD Guidelines, were developed to provide Egyptian taxpayers with detailed guidance on how to prepare documentation to support the arm's-length nature of their transactions as required by Income Tax Law No. 91 of 2005. The ETA, together with the Ministry of Finance, views TP as a key legislative initiative. Egypt was one of the first countries in the Middle East and North Africa to introduce specific TP rules in its tax code, and the first to release TP guidelines in Arabic. Transfer pricing laws were enacted in 2005 through Egyptian Income Tax Law No. 91 and its related Executive Regulations.

Egypt has Double Tax Treaties (DTT) with approximately 50 countries. Most, if not all, Egyptian DTTs have been drafted according to the OECD model convention. With regard to application, treaty provisions are honoured by the ETA in most cases; however, recently some limitations have been placed on their application. Competent authority proceedings are not regularly used in Egypt.

Legislation and guidance

Transfer pricing in Egypt is governed by Income Tax Law No. 91 of 2005, Article (30) and its Executive Regulations, Articles (38), (39), and (40), collectively (TP Law). TP Law defines the arm's-length principle, related parties and the TP methods together with the priority in which such methods should be applied. TP Law is applicable to international and domestic transactions between related parties. As such, TP Law is applicable to transactions carried out with parties in foreign tax jurisdictions or regimes and to domestic transactions with Egyptian free zones or local related parties operating within Egypt.

The Egyptian Transfer Pricing Guidelines define a related party as any person who has a relationship with a taxpayer that may lead to an effect on that taxpayer's taxable profit. Based on TP Law, related parties include:

- A husband, wife, ancestors and descendants (family members).
- Capital associations and a person that holds at least 50% of the value of shares or voting rights, whether directly or indirectly.
- Partnerships, the joint partners and silent partners of those partnerships.
- Any two or more companies where a third party holds 50% or more of the value of shares or of the voting rights in each company.

Additionally, the Egyptian Transfer Pricing Guidelines explicitly list the following methods in order of priority of application:

Traditional transaction methods:

- Comparable Uncontrolled Price (CUP) method.
- Resale Price (RP) method.
- Cost plus (CP) method.
- Transactional profit methods:
- Profit Split (PS) method.
- Transactional Net Margin Method (TNMM).

Other methods:

- Global Formulary Apportionment.

Additionally, article (30) of the Egyptian tax law as well as Article (39) of the Executive Regulations, contain a provision stating that the head of the ETA may conclude agreements with related parties in respect to one of the available TP methods for determining an arm's-length result. In theory, this provision potentially enables advance pricing agreements (APAs) to take place, although, to date, no formal APA application process has been established in Egypt.

The ETA announced that the Egyptian Transfer Pricing Guidelines will be issued as a series of parts, beginning with the part issued in November 2010. The first part focuses on providing guidance on primary TP concepts and issues, including the arm's-length principle, comparability analysis, TP methods, and documentation requirements.

The next parts of the Egyptian Transfer Pricing Guidelines are expected to address other more advanced issues, such as the application of the arm's-length principle to transactions involving intangible property (IP), intra-group services, cost contribution arrangements (CCAs), and APAs.

Penalties

ETA penalties, which are provided under the general corporate tax provisions in Article (136), can be up to 40% of the income adjustment. The specific penalty provisions state that if the tax payable (stated in the tax return) by the taxpayer is less than the final assessed tax, then the taxpayer is subject to a penalty based on the percentage of the excluded tax amount:

- 5% of the tax payable on the excluded amount if such amount is equivalent to 10% up to 20% of the due tax.
- 15% of the tax payable on the excluded amount if such amount is equivalent to more than 20% up to 50% of the due tax.
- 40% of the tax payable on the excluded amount if such amount is equivalent to more than 50% of the due tax.

Documentation

Since issuance of TP law, the corporate tax return has included disclosure requirements for related party transactions and general disclosure regarding a taxpayer's TP policies. The tax return inquires about a taxpayer's contribution in resident and non-resident subsidiaries and sister companies, specifically, the percentage and the value of the contribution as well as the annual yield from the contribution.

The tax return also includes disclosure of direct and indirect related-party transactions with a certain amount of detail, specifically, requiring disclosure of the related party name, the type of relationship, characterisation of the transaction, as well as the value of the related-party transactions for the return year and the preceding year. Additionally, the taxpayer is required to disclose the TP method chosen under TP law and the parties to the transaction.

Taxpayers are required to prepare contemporaneous documentation studies to support the arm's-length nature of their controlled transactions. However, the Egyptian tax authority does not require the submission of TP documentation studies with the tax return; rather, they are required to be available upon request in a tax audit. Studies are acceptable in English, but a translation may be requested from the taxpayer.

Transfer pricing controversy and dispute resolution

Since 2005, TP law has been based on a self-assessment system and there has been very limited practical experience of TP audits under current TP Law.

The TP Law places burden of proof on the ETA, provided that the taxpayer can produce sufficient TP documentation (and other supporting documents, including potentially intercompany agreements, schedules, and invoices) to support its declared transactions on the tax return. According to the TP Law, however, the burden of proof shifts to the taxpayer in the event that the tax return is not filed or the taxpayer fails to produce proper TP documentation to support its tax return positions.

There have been no specific TP cases in Egyptian courts. However, the ETA has had a tendency to challenge structures/transactions where there is inconsistency between the legal form and the economic substance of the arrangement. Where such inconsistencies have been apparent, the ETA has historically sought to adjust transactions such that it tests the outcome of the transaction based on the form of the transaction as well as based upon the economic substance of the transaction. This has been done many times on an arbitrary basis.

Starting September 2014, the ETA established a specialist transfer pricing unit tasked with TP related subject matters. More recently, the ETA's specialist transfer pricing unit issued formal request letters to taxpayers operating in Egypt with related-party dealings requesting them to submit TP documentation reports for a number of years, ranging from 2010 through 2014. This is considered a formal inauguration of the specialist transfer pricing unit to request and review TP documentation reports which will be followed by conducting TP specific audits. However, no TP specific audits have been conducted to date.

Comparison with OECD Guidelines

Egyptian Transfer Pricing Guidelines were compared to the OECD Guidelines by an OECD representative and were found to be similar. However, the hierarchy of methods remains in the Egyptian Transfer Pricing Guidelines along with the Egyptian Transfer Pricing Guidelines' four-step approach.

34.

El Salvador

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Overview

Salvadoran legislation includes the general principles for dealing with transactions carried out with local and/or foreign related parties. In February 2014, the Salvadoran Tax Administration published an updated version of the informative return of transactions between related parties (Transfer Pricing Informative Return or Form 982 v3), which supersedes the form used until fiscal year 2012.

Country	**El Salvador**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	A deadline for preparing TP documentation is not provided. However, the tax authorities can request the TP documentation at any time. It is important for the taxpayer to have the documentation in the first five months of the year for the presentation of the fiscal report.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No. There is a specific tax return disclosure of related-party transactions.

El Salvador

Country	El Salvador
Penalties	
Are there fines for not complying with TP documentation requirements?	No. The Salvadoran Tax Code does not contain penalties for not complying with this formal obligation.
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	N/A

Introduction

Legislative decree No 233 enacted on 16 December 2009 introduced modifications to some articles in the Salvadoran Tax Code, where it was established the obligation of evaluating the arm's-length nature of transactions between related parties, the criteria to be used to determine the entities qualified as related parties and the obligation of disclosure of the transactions carried out with related parties through an informative return (Transfer Pricing Informative Return or Form 982).

On 23 March 2012, the Salvadoran Tax Administration issued the Orientation Guide No DG 001/2012 (Guide No 001/2012) with the purpose of providing taxpayers with guidance on the proper tax treatment of transactions between related parties, or transactions with entities domiciled in tax havens. Although El Salvador is not a member of the Organisation for Economic Co-operation and Development (OECD), Guide No 001/2012 recognised the arm's-length principle definition established in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).

On 5 February 2014, the Tax Administration issued a new version of Form 982, which includes a Section C entitled, 'Supporting documentation to determine the prices in transactions with related parties or entities domiciled, constituted or located in countries, jurisdictions or territories with preferential tax regimes, low or no taxation regimes'. In this section, the taxpayer must indicate the type of documentation in existence to support related-party transactions. In case a third party is contracted by the taxpayer preparing such documentation, the third party's name and tax identification (ID) must be specified.

In July 2014, Article 62- A of the Tax Code, which establishes the determination of transfer pricing (TP), was reformed by Legislative Decree. With this reform, a second clause was added in this Article, whereby it is established that the taxpayers shall determine the arm's-length price using the procedures and technical methods contained in the Tax Code as well as the OECD Guidelines.

In addition, with this reform, the implementation of the OECD Guidelines obtained force of law. It is important to mention that prior to the reform; the implementation of the methodology of the OECD Guidelines was based on a guidance issued by the Salvadoran Tax Administration.

Legislation and guidance

Salvadoran tax code

Article 62-A establishes the obligation of the taxpayer that engages in transactions with related parties, to determine the prices for those transactions in a manner consistent with the determination of prices used in the transfer of goods or services of the same kind between third parties. The same obligation applies for transactions between entities domiciled in jurisdictions considered as tax havens.

Article 199-C provides the criteria for determining whether a subject or entity may be considered as a related party.

Article 199-D includes comparability criteria which states that companies or transactions are comparable when none of the differences (if any) between the situations compared could materially affect the price or profit margin, and that reasonably accurate adjustments can be made to eliminate the effect of such differences. In order to determine those differences, the required elements that must be considered include the following:

- Characteristics of the operations.
- Functions or operations including the assets used and risks assumed by each of the parties involved.
- Contractual terms.
- Economic circumstance.
- Business strategies, which refer to market penetration, permanence and expansion schemes.

Article 199-D also establishes that the prices used by comparable unrelated companies can be adjusted if significant differences exist between the tested party and the unrelated comparable companies. In such cases, adjustments to the operating profit, operating assets, or both, can be made to the tested party or to the unrelated comparable companies.

Article 124-A establishes the obligation to file an inter-company transaction informative return, which must be presented three months after the fiscal year-end. The informative return is presented when these transactions (separate or altogether) are more than 571,429 United States dollars (USD).

Guide No DG 001/2012

Guide No DG 001/2012 introduces the TP methods stipulated in the OECD Guidelines, which include:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Transactional net margin method.
- Profit split method.

According to Guide No. DG 001/2012, taxpayer documentation must contain:

- information and documentation of the corporate group from which the taxpayer belongs
- documentation of the taxpayer (complete ID of the taxpayer and the related parties, detailed description of the nature, characteristics and import of the transactions between related parties, comparability analysis and selected TP methodology), and
- structure of the documentation and information.

Penalties
Failure to file Form 982 on the established dates can result in a penalty of 0.5% over the equity that is stated in the general balance, minus the surplus for the asset's revaluation not deducted. The fine cannot be less than three minimum wages. General penalties on income tax adjustments may apply.

Documentation
The Salvadoran legislation does not establish a specific deadline to prepare TP documentation; however, Salvadoran taxpayers must file a *dictamen fiscal* in May and the independent accountant must disclose if there is a TP report in place.

Guide No 001/2012 establishes that the information and documentation may be structured as follows:

- Executive summary
- Functional analysis
- Industry analysis
- Economic analysis

Transfer pricing controversy and dispute resolution
The statute of limitation for TP obligations according to Salvadoran legislation is three years in case the tax return is filed on time, and five years in case the tax return is not filed. The burden of proof lies with the taxpayer to demonstrate that the transactions between related parties comply with the arm's-length principle.

The Salvadoran legislation does not establish the possibility of advance pricing agreements.

Comparison with OECD Guidelines
El Salvador is not a member of the OECD; nonetheless, El Salvador does follow the OECD Guidelines. Guide No 001/2012 does make allusion to the OECD standards.

35.

Equatorial Guinea

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Overview

There has not been any changes or new provisions in the current transfer pricing (TP) rules in Equatorial Guinea and the existing rules remain very general and imprecise (please refer to our comments below). Transfer pricing matters are, however, being more and more carefully assessed in the framework of tax audits, to the point that now it is almost systematically a subject on which several queries are raised. In this scenario, companies almost entirely rely on the decisions and measures taken in the framework of previous tax audits to determine which route to follow.

Country	**Equatorial Guinea**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes, however, there are no specific TP documentation rules in place.
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	It is recommended that any transaction is included in a TP document which is put in place before the execution of the transaction.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes

Equatorial Guinea

Country	Equatorial Guinea
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Fixed amounts are stated in the tax code

Introduction
Equatorial Guinea's legal system and the Economic and Monetary Community of Central Africa's (CEMAC) regulations do not include specific TP rules.

Legislation and guidance
Section 164 of Law Nº 04/2004 dated 28 November 2004, which regulates the taxation system of the Republic of Equatorial Guinea, only includes general rules regarding the prohibition of direct or indirect transfer of income or profits to foreign affiliated companies under dependence and control of companies established abroad, either by reducing or increasing their sale or purchase prices (or by any other means).

In order to assess such transfers, the tax authorities may use a comparative method with similar entities operating in the same economic sector in Equatorial Guinea.

In terms of sections 51 and 52 of CEMAC's Directive related to corporate income tax (for companies under the control of companies or groups located outside the CEMAC zone), payments made by whatever means are considered as transfer of profits if the transfer includes:

- an increase in the purchase price or a decrease in the sale price
- payment of any excessive royalties or use of intellectual property without paying any consideration
- loans without interest or at an unjustifiable interest rate
- reduction of debts, and
- benefits that are out of proportion in relation to the service rendered.

The amounts paid in respect of the use of patents, marks and designs, interest payments, as well as payments for services carried out by a company located in the CEMAC zone to a foreign company located in a low or nil tax country, may be adjusted by the tax authorities if the company does not have evidence to show that the payments refer to actual transactions and are not excessive.

Penalties
In the event of reassessment, companies can be subject to penalties, which are 50% of the amount of the tax under payment. In the event that the taxpayer acts in bad faith, penalties can reach 100% of the tax that has been avoided.

Documentation
There are no specific TP documentation rules. However, if companies prepare TP documentation, it should be prepared in one of the official languages of Equatorial Guinea (Spanish, French or Portuguese).

Transfer pricing controversy and dispute resolution
Not applicable

Comparison with OECD Guidelines
Not applicable.

Equatorial Guinea

36.

Estonia

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Overview

Transfer pricing (TP) is becoming an increasingly important tax issue in Estonia and the number of TP audits and related information requests has continuously increased. However, Estonian TP practice is currently not very sophisticated, as both taxpayers and tax authorities are building their TP expertise.

Country	**Estonia**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Submitted within 60 days from request
Must TP documentation be prepared in the official/local language?	No, but translation may be requested.
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Mainly as late payment interest

Introduction

Estonian TP regulation relies strongly on the principles stated in the Organisation for Economic Co-operation and Development (OECD) Guidelines, stipulating solid rules for implementing the regulation in practice.

Estonia

Estonian tax authorities as well as the taxpayers are in the process of developing TP expertise. There is some court practice providing guidance in areas such as management services, loss-making operations and financing arrangements as well as administrative guidelines supporting the implementation of the statutory TP regulation.

Legislation and guidance

Statutory rules

Estonian TP rules are stipulated in the Income Tax Act and in Regulation No. 53 issued by the Estonian Ministry of Finance on 10 November 2006. Estonian taxpayers are required to be able to demonstrate that both domestic as well as cross-border transactions with related parties were conducted at arm's length. Transfer pricing rules are applicable to all types of transactions.

Transfer pricing rules are applicable to inter-company transactions concluded between the following parties:

- An Estonian company and its related party.
- An Estonian sole proprietorship and its related party.
- An Estonian permanent establishment (PE) and its foreign head office.
- An Estonian PE and a party related to its foreign head office.
- An Estonian company and its foreign PE.

Related parties

Estonian tax legislation provides a rather broad definition of related parties. The following companies and individuals qualify as related parties:

- An Estonian company and its group company.
- An Estonian company and a direct shareholder that owns more than 10% of the share capital, number of votes or rights to the profits of the company.
- An Estonian company and two or more direct shareholders, which qualify as related parties to each other and own (on a combined basis) more than 50% of the share capital, number of votes or rights to the profits of the Estonian company.
- An Estonian company and another company that has a common shareholder, which owns more than 50% of the share capital, number of votes or rights to the profits of both of these companies.
- An Estonian company and another party that each separately own more than 25% of the share capital, number of votes or rights to the profits of the same legal entity.
- An Estonian company and another legal entity that have exactly the same members of their respective management boards.
- An Estonian company and its employees, members of management and supervisory board, and direct relatives of these persons.

Companies not covered by the above list of related parties may still be regarded as related parties if they have a mutual business interest or control. There is no administrative practice in place or guidelines issued by the tax authorities explaining the notion mutual business interest, but in essence this is regarded as an anti-avoidance clause.

Transfer pricing principles
The Estonian regulation is based on the arm's-length principle, which requires the prices charged between related parties be equivalent to those that would have been charged between independent parties performing the same or similar functions under the same or similar circumstances. Should the transfer prices applied in the inter-company transactions not follow the arm's-length principle, any hidden distribution of profits is subject to Estonian corporate income tax (20/80 on net amount of profit distribution).

Under the present Estonian corporate income tax system, TP adjustments are treated as deemed dividend distributions subject to corporate income tax. Consequently, TP adjustments do not increase the taxable income of the taxpayer and are not treated as non-deductible for corporate income tax purposes. Therefore, a TP adjustment assessed to a loss-making company triggers corporate income tax payable.

The Estonian TP regulation provides guidelines regarding comparability of the transactions in respect of the functional analysis and contractual terms of the transaction as well as economic circumstances and business strategies. The Estonian regulation also establishes guidelines for intellectual property (IP), provision of intragroup services and cost contribution agreements.

Transfer pricing methods
The Estonian regulation introduces five TP methods that are the same as those in the OECD Guidelines:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Profit split method
- Transactional net margin method.

In addition, the taxpayer is entitled to apply its own method, provided that it achieves a more reliable result.

The Estonian regulation recognises the 'best method rule' for selecting the applicable TP method. As a result, each transaction or group of transactions must be analysed separately in order to determine the most appropriate method and that there is no priority of the methods. Furthermore, the regulation does not prescribe any obligatory method for certain types of transactions, and the taxpayer is entitled to apply only one method for calculating transfer price for a transaction.

Estonian corporate income tax system
Estonia has a rather exceptional corporate income tax regime which should be considered while applying the TP regulation. Under the Estonian corporate income tax regime, all undistributed corporate profits are tax-exempt.

This exemption covers both active (e.g. trading) and passive (e.g. dividends, interest, royalties) types of income, as well as capital gains from sale of all types of assets including shares, securities and immovable property. This tax regime is applicable to Estonian companies and PEs of foreign companies that are registered in Estonia.

Estonia

In Estonia, corporate profits are not taxed until the profits are distributed as dividends or deemed profit distributions, such as TP adjustments, expenses and payments that do not have a business purpose, fringe benefits, gifts, donations and representation expenses. Registered PEs (including branches) are subject to corporate income tax only in respect of profit distributions, both actual and deemed, as defined in domestic law.

Distributed profits are generally subject to 20% corporate income tax (20/80 on the net amount of profit distribution).

The period of taxation is a calendar month. The combined corporate income tax and payroll tax return (form TSD with appendices) must be submitted to the local tax authorities and the tax must be paid by the tenth day of the month, following a taxable distribution or payment.

Legal cases

There have been few cases either resolved in the framework of administrative objection procedure or brought to court. The cases have concerned topics such as duplicative services, stewardship costs, selection of external comparables, and consolidation of transactions. There is also some case law practice on financing transactions.

Penalties

Taxpayers are liable to self-assess the arm's-length nature of inter-company transactions. Any TP adjustment must be declared and the tax remitted monthly, as the period of taxation is a calendar month. The combined corporate income tax and payroll tax return (form TSD with appendices) must be submitted to the local tax authorities and the tax must be paid by the tenth day of the month, following a taxable distribution or payment.

Tax arrears bear late payment interest (0.06% per day) and 20/80 corporate income tax will be levied on late payments' interest paid. In certain circumstances, TP adjustments may also trigger double taxation. There are no special TP penalties.

Tax returns are open for investigation generally for three years from the dates of submission. This statute of limitation can be extended for another two years if the authorities discover intentional non-payment of tax.

Documentation

The Estonian TP regulation introduces documentation requirements applicable, starting from 1 January 2007. As a general rule, all Estonian group companies and PEs are obliged to prepare TP documentation to prove the arm's-length nature of the inter-company transactions.

An exemption applies to small- and medium-sized enterprises (SME) unless they have conducted transactions with entities located in low-tax territories. A company or PE is deemed to be an SME, provided that the previous financial year's consolidated results of an Estonian company or a PE together with its associated enterprises or head office meets all of the following criteria:

- Annual sales less than 50 million euros (EUR).
- Balance sheet less than EUR 43 million.
- The number of employees is less than 250.

Although the formal TP documentation requirements do not apply to SMEs, they may still be required to prove the arm's-length nature of their inter-company transactions to the tax authorities in the course of a tax audit. There are generally no limitations and restrictions in relation to the form or type of evidence the taxpayer can submit to defend transfer prices.

The Estonian documentation requirements should generally follow the principles stipulated in the European Union (EU) Council Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the EU. The master file and country-specific files including supporting documentation, should be prepared by the taxpayer with due diligence considering the nature and extent of the controlled transactions.

The master file should contain a business profile of the group, a list of related parties with business profile descriptions, details of controlled transactions, a functional analysis, a list of IP owned by the group, a description of the TP policy, and a list of any applicable cost contribution and advance pricing agreements (APAs). Country-specific files should include a business profile of the taxpayer, description of intragroup transactions, comparability analysis, and the selection of TP method and identified comparables.

Transfer pricing documentation should be submitted to the tax authorities within 60 days of their request. The TP documentation does not have to be in Estonian, but the tax authorities may ask the taxpayer for a translation.

Other than the formal TP documentation and general requirement to disclose the transactions with the related parties in the annual reports, there are no additional reporting requirements related to TP in relation to inter-company transactions.

Transfer pricing controversy and dispute resolution

Burden of proof

As a general rule, the burden of proof lies with the taxpayer, as the taxpayer is required to prove the arm's-length nature of the inter-company dealings. If the taxpayer has submitted proper documentation, the burden of proof is shifted to the tax authorities, who must demonstrate why the taxpayer's transfer prices are not at arm's length and support it with adequate documentary evidence in order to challenge the transfer prices of the taxpayer. Once the tax authorities have proposed an alternative TP method or comparables, the burden of proof again shifts to the taxpayer to defend the arm's-length nature of its transfer prices.

Tax audit procedures

Estonian tax authorities have tax inspectors who specialise in TP. Tax authorities perform special TP audits as well as review the pricing of inter-company dealings in the course of a general tax audit where TP is audited simultaneously with other types of taxes.

The TP audit procedures must follow the general tax procedures established for tax audits. The tax authorities may request all relevant data, such as accounting records and other supportive documentation, and have interviews with the management and employees. Information may also be requested from third parties including credit institutions.

The tax audit is usually finalised with the submission of a written report of the tax findings to the taxpayer. The taxpayer is entitled to file a written response, accompanied by additional documentary evidence, if necessary. Any resulting TP adjustment is imposed by the appropriate local tax office of the tax authorities.

Revised assessments and the appeals' procedure

Additional assessments and any penalties imposed by the tax authorities can be appealed by the taxpayer within 30 days of receipt of the tax verdict. The appeal may be submitted to the tax authorities, with review of the appeal occurring generally within 30 days. If the appeal is unsuccessful, the taxpayer is entitled to submit a new appeal to the court within 30 days of receiving the decision from the tax authorities. As an alternative, the taxpayer may submit an appeal directly to the court; appealing first to the tax authorities is not obligatory.

As a general rule, regardless of whether an appeal has been submitted, the taxpayer is required to pay the imposed tax within 30 days of receipt of the tax verdict. Under certain circumstances, the tax authorities or court may postpone the payment of tax until the dispute is resolved. Should the appeal be successful after the tax has been deposited by the tax authorities, overpayment of tax bears late payment interest amounting to 0.06% per day, payable to the taxpayer.

Relief from double taxation in cross-border inter-company transactions can be sought through the tax treaties concluded by Estonia that, in most cases, include provisions for a mutual agreement procedure. Estonia has also ratified the Arbitration Convention (90/436/ECC), which should provide relief from double taxation related to tax disputes inside Europe.

Currently, there are no provisions enabling taxpayers to negotiate APAs with the tax authorities.

Comparison with OECD Guidelines

Estonia is a member of the OECD and the taxpayers and Estonian Tax and Customs Board are *expressis verbis* encouraged to apply OECD Guidelines for interpreting and implementing the Estonian regulation in situations where OECD Guidelines do not contradict the Estonian regulation.

The Estonian TP regulation should generally be in line with the principles laid down in the OECD Guidelines. However, there are some Estonian-specific issues (e.g. preference of local comparables) that should be considered when applying the OECD Guidelines. Furthermore, sufficient attention should be paid to the present Estonian corporate income tax system, which taxes only direct and deemed profit distributions.

It remains to be seen how the tax authorities will view the OECD initiatives on addressing the international issue of base erosion and profit shifting among multinationals.

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Finland

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Overview

In 2012, all transfer pricing (TP) audits were centralised in the Tax Office for Major Corporations and it has increased the number of authorities concentrating on TP. The TP environment has tightened significantly during the last couple of years. Tax authorities have been very aggressive in audits and their approach in tax assessments. Tax authorities require detailed information and the TP audits can take several years.

In July 2014, the Supreme Administrative Court gave a significant decision regarding TP, based on which, disregarding or recharacterisation of the intragroup transaction cannot be made, based on Section 31 of the Act on Assessment Procedure, which includes the arm's-length principle.

Country	**Finland**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	To be provided within 60 days upon request
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Max. 25,000 euros (EUR) per negligence

Finland

Introduction

The bill containing legislation on TP documentation rules has been in effect from 1 January 2007. This has significantly increased the number of TP audits in Finland. Since January 2012, all TP issues were centralised at the Large Taxpayers' Office. Transfer pricing is one of the key areas of a tax audit and applies to Finnish multinationals as well as to Finnish subsidiaries of foreign multinationals. The TP team at the Large Taxpayers' Office has also increased the number of tax audits. Moreover, monitoring of TP will be primarily done through tax audits instead of standard annual assessments.

Legislation and guidance

Transfer pricing adjustment

Article 31 of the Assessment Procedure Act (VML) prescribes the arm's-length principle for related-party transactions. According to Art 31 VML, in the event that a taxpayer and a related party have agreed upon terms or defined terms that differ from the terms that would have been agreed upon between independent parties and, as a consequence, the taxable income of the taxpayer falls below, or the taxpayer's loss increases, compared to the amount that the taxable income would otherwise have been, the taxable income may be increased to the amount that would have accrued in case the terms had followed those that would have been agreed upon between independent parties. Related-party transactions are defined on the basis of direct or indirect control. The arm's-length requirement also applies to transactions between the company and its permanent establishment (PE).

Documentation

The documentation rules are contained in Articles 14a–14c of the Assessment Procedure Act and provide that documentation establishing the arm's-length nature of transactions between related parties should be drafted on cross-border transactions.

Other guidance

On 19 October 2007, the tax authorities published guidelines dealing specifically with documentation. The Organisation for Economic Co-operation and Development (OECD) Guidelines on TP, while not legally binding in Finland, are important in practice. Decisions of the Finnish courts are compatible with them. Finnish legal commentary also follows the principles in the Guidelines.

Penalties

A failure to comply with the documentation requirements could result in a tax penalty being applied. In case the required documentation or additional information is not submitted in a timely manner, or if the information submitted is essentially incomplete or incorrect, a tax penalty of a maximum EUR 25,000 could be imposed.

Penalties may be charged where an additional assessment is made. A punitive tax increase is levied in cases of deliberate or negligent returns, which may amount to up to 30% of the increase of the taxable income, usually being between 5% and 10%. If the taxpayer has tried to verify the arm's-length nature of the TP due and this can be demonstrated in the TP documentation, no penalty tax increase will be imposed.

Penalty interest on overdue tax payments is based on the reference rate plus 7%. Penalties, punitive tax increases and penalty interest are not tax-deductible.

Documentation

According to the rules, the Finnish TP documentation should include the following:

- Description of the business.
- Description of related-party relationships.
- Details of controlled transactions.
- Functional analysis.
- Comparability analysis including information on comparables, if available.
- Description of the pricing method and its application.

The description of the business should contain a general description of the business of the taxpayer and the group the taxpayer belongs to. The description could include recent history of the group, a description of the taxpayer's position on the market, and information on business environment and the taxpayer, any of which can be used to evaluate circumstances affecting the TP. It is separately stated in the government proposal concerning the TP legislation that it is important to describe the business strategy and changes to the business strategy. It should also be noted that the business description needs to be relevant to the TP of the company.

The description of the related parties should include information on related parties with whom the taxpayer has had business activities during the tax year, or whose business activities affect, directly or indirectly, the pricing of the transactions between the taxpayer and a related party. The information should include the basis for the related-party relationship and the organisational structure of the group.

Details of controlled transactions should include the following information on intragroup transactions:

- Type.
- Parties.
- Value in euros (EUR).
- Invoicing flow.
- Contractual terms.
- Relationship to other transactions with related parties.

In addition, a list of relevant agreements (including copies of the most important agreements) should be included along with a list of cost allocation agreements, advance pricing agreements (APAs) and advance rulings, and any rulings issued by the tax authorities to the other party of the transaction.

The aim of the functional analysis is to analyse the transactions between related parties by taking into account the functions, assets and risks involved. Identifying the intangible property is extremely important. In addition, the risks of each party should be carefully analysed. It is stated in the tax authorities' guidance that a detailed description of both parties is required.

The comparability analysis compares the related-party transactions to unrelated-party transactions. The analysis should include the factors affecting the comparability including the functional analysis, the nature of the transferred assets or services, the terms and conditions, and the economic factors affecting the parties. Information on

the search for comparables should also be included (i.e. information on the selection criteria, arguments, factors affecting the comparability and any adjustments made).

No comprehensive Finnish databases containing third-party comparable information are available. However, the tax authorities have subscribed to common commercial databases, which are used for the purposes of obtaining comparable third-party data. This data is regularly used as a basis for suggested assessments.

According to TP legislation, a comparability analysis should include the factors affecting the comparability, e.g. the functional analysis, the nature of the transferred assets or services, the terms and conditions, and economic factors affecting the parties. Finnish TP documentation need not include a benchmark study for external comparables. In practice, this means that no documentation penalties are levied, even though the TP documentation does not include a benchmark study. However, unless the company provides comparables to support its TP, the tax authorities are likely to perform a search during their audit.

It is stated in the legislative proposal that, in accordance with the EU Code of Conduct on European TP documentation, pan-European comparables' searches should not be disregarded offhand. However, in practice, European-wide comparable searches are regularly challenged in cases where the tax authorities have succeeded in finding comparable data on Finnish or Nordic companies.

The description of the pricing method and its application should include the reasoning for the selection of the method, as well as a clarification of the method applied. The clarification should include calculations used to verify the arm's-length nature and details on adjustments made. Assumptions made and conclusions drawn should also be described.

Transfer pricing documentation should be submitted to the tax authorities within 60 days from a request. However, a taxpayer would not be required to submit TP documentation earlier than six months after the end of the accounting period in question. Additional information requests should be complied with within 90 days of the request.

Based on the above, no contemporaneous documentation during the tax year would be required. However, the legislative proposal states that a taxpayer should monitor its transfer prices during the tax year, as it is not possible to amend the taxable income downward on a tax return in Finland. During the tax year it is possible to make an adjustment to bring pricing in line with the arm's-length principle; such an adjustment would be included in the calculation of taxable income.

A relief from the documentation requirement is being applied to small and medium-sized enterprises (SMEs). These enterprises do not need to prepare TP documentation. The definition of SMEs follows the European Commission recommendation 2003/361/EC. Consequently, the relief will, in principle, apply to companies belonging to a group with turnover of no more than EUR 50 million or a balance sheet of no more than EUR 43 million and less than 250 employees. Employees include those employed in a group or company, full- or part-time workers, seasonal workers and owners who participate in managing the company. The number of employees is expressed in annual working units, where a full-time worker is one unit and the other workers are divided in partial units.

If the requirements of an SME are exceeded during a year, the documentation requirements will not be imposed during that year.

According to the Finnish tax authorities, the requirements for TP documentation can be fulfilled with EU TP documentation.

In terms of the language to be used in the documentation, the proposal for legislation states that TP documentation should be accepted even if it was drafted in English. A translation to Finnish or Swedish should be required only when it is necessary for the purposes of conducting the taxation of the entity in question.

Disclosure on tax return

Taxpayers are required to disclose on their annual tax return whether they have had related-party transactions during the tax year in question and whether they are obliged to maintain TP documentation provided in Section 14a of the Assessment Procedure Act. Beginning from tax year 2009, taxpayers who obligated to maintain TP documentation are also required to file an additional tax return form (Form 78) describing the intragroup cross-border transactions and their volumes. However, Form 78 is not intended for explanations of TP methodology.

Transfer pricing controversy and dispute resolution

Burden of proof

The burden of proof is said to reside with the party that can best provide the required evidence. Generally, however, the burden of proof rests with the taxpayer. Consequently, where the authorities have questioned whether transactions between related parties have taken place at arm's-length prices, the taxpayer, who in any event is the party best able to provide the evidence required, must prove their case.

Tax audit procedures

Selection of companies for audit

A TP audit is performed separately from the ordinary tax audit. As a general rule, the authorities try to audit the largest companies at least once every five years. Also, as a general rule, companies are selected to be audited, based on their line of business or specific tax risk criteria, developed by the tax authorities. The tax authorities are interested in high-risk companies, but the tax authorities have stated that medium-sized companies also will be one of the focus areas of the TP project. However, the tax authorities do not disclose information concerning their tax-risk analysis process.

As of tax year 2009, taxpayers are required to file a tax return form (Form 78) describing the intragroup cross-border transactions and their volumes. Form 78 will be used as background information for audit selections.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The tax authorities may request all data, material and property that they believe is necessary to audit the tax return or to agree on an assessment or appeal, such as books and records, and other documents, etc. Information may also be requested from third parties, and certain entities, such as banks, and investment and insurance companies, must disclose information on request. The tax authorities collect information also by interviewing the key personnel of the relevant business areas. The information also covers documents and financial information on other group entities.

The audit procedure
A tax audit would usually include a visit to the company's business premises and interviews with personnel including examination of correspondence on issues arising during the audit.

While the taxpayer has a right to be heard in the audit process, this does not amount to actual negotiation. The tax auditors make a decision as to the amount of the assessment, based upon the facts they have gathered from the taxpayer and other sources. The tax auditors will prepare a tax audit report, against which the taxpayer may give a written response. The report may include a proposal for an adjustment. An adjustment is imposed by the tax office as appropriate.

From the beginning of 2015 the tax authorities have changed their focus from the tax audits into the provision of the advance guidance to the taxpayers. However, at the moment there is only little practical experience available on the advance guidance.

Joint investigations
It is possible for Finland to join with another country to undertake a TP audit. Joint investigations have been carried out in practice, especially with other Nordic countries.

Assessments and the appeals procedure
An appeal may be lodged against any adjustment in the same way as against an ordinary assessment. A taxpayer has the right of appeal to the Adjustment Board in the first instance. The appeal must be made no later than the end of the fifth year following the year of assessment, but in every case, however, within 60 days of receiving notification of the assessment. An appeal against a decision of the Adjustment Board may be made to an Administrative Court and must be made within similar time limits. Appeals against the decision of the Administrative Court must be made to the Supreme Administrative Court within 60 days of the decision, and only if the Court grants permission to do so. Leave to appeal to the Supreme Administrative Court would be granted on the basis of the following criteria:

- The appeal has an important bearing on similar cases or would secure uniformity of legal practice.
- An error in procedure or other error has taken place in the case, which by virtue of law requires the decision to be reversed.
- There are other weighty grounds for granting permission to appeal.

Risk transactions or industries
There is no tendency to single out any one business sector. It is clear, however, that in the past there has been a tendency to examine service fees and royalties, rather than the transfer price of goods.

For the moment, financial transactions, valuation of intangible assets, royalty payments and business restructuring, especially, seem to be scrutinised by the Finnish tax auditors.

Tax auditors have recently paid attention to the group's internal financial arrangements. In many tax audits the arm's-length interest rate of intragroup loans or cash pool has been questioned. Furthermore, in some cases cash-pool receivables or liabilities have been recharacterised as long-term receivables or liabilities. Financial transactions may draw the tax auditors' attention if domestic subsidiaries' interest

expenses are considerably high, interest incomes are very low or the intragroup loans are not interest-bearing. In some cases, a holding company structure has been challenged and business reasons for the structure have been requested.

Valuation of intangible assets is being scrutinised by the Finnish tax auditors, especially in cases of business restructurings when the intangible assets are being transferred from Finland to a foreign group company. In addition, practical experience shows that tax auditors quite often question both the justification of royalty payments for intangible property and the amount of royalty paid. In particular, royalties for trademarks have been questioned in several cases.

Furthermore, the current practice shows that TP audits related to PEs have been increased and the allocation of profits to the PE has been questioned.

Limitation of double taxation and competent authority proceedings

Finland has created a reservation to the OECD Model tax treaty concerning the use of the competent authority process. This does not mean that the process will not be used at all, but rather that it will not automatically be used. In fact, Finland has concluded several tax treaties that include competent authority clauses.

The number of competent authority cases is increasing but the process is long.

Advance pricing agreements (APA)

In TP matters, advance ruling can be given by the Tax administration on the application of the taxpayer. In addition, the Central Tax Board can give advance rulings on application of the taxpayer in cases that are important for the implementation of the law in similar cases, or the consistency of the tax practice, or if there is other heavy arguments for the advance ruling. In TP cases the outcome is based on the valuation of the arm's-length amount on the case-by-case basis, and so advance ruling usually cannot be obtained from the Central Tax Board.

Currently, there is no APA legislation in place, but it is possible to apply for an APA based on the tax treaty (mutual agreement procedure APA).

Legal cases

Several cases have been brought to court which establish some principles for dealing with TP and illustrate how the arm's-length rule can be applied in practice. Some of the rulings of the Finnish Supreme Administrative Court are set out below. However, to date, there is no published legal case dealing with TP documentation.

Case 1990/483

A Finnish company paid penalty interest to its Swedish parent company in respect of payments made after the due date. The parent company had not paid penalty interest on similar late payments to the Finnish subsidiary. In these particular circumstances, the penalty interest was held to be a hidden distribution of profit as defined in section 73 of the Assessment Act.

Finland

Case 1986/3441
A Finnish company that manufactured and marketed fishing lures sold 90% of its products by exporting the majority to North America. In 1981, it established an Irish subsidiary. Two models in the product range were exported incomplete to Ireland, where they were finished and sold to the North American market. The Irish company benefited from favourable tax rates in the first ten years of its activities.

In the next tax year, the parent company sold blanks to Ireland for FIM 916,488 and, after production costs of FIM 724,856, made a profit of FIM 191,632 or a gross profit margin of 20.9%. The Irish company finished these blanks and sold them in the North American market for FIM 4.3 million and, with associated costs of FIM 1.9 million, the Irish company made a profit of FIM 2.4 million or a gross profit margin of 55.8%.

The Court held that the transfer price was different from what would have been agreed between two parties acting on an arm's-length basis. The taxable profit of the Finnish parent was increased by FIM 291,605, to take into account the hidden profit distribution to the subsidiary.

Case 1993/3009
A Finnish company, whose main activities were photographic development and wholesaling of photographic products, entered into a marketing services agreement with its US-resident parent company under which it received technical and marketing assistance in return for an annual fee. The fee was based on an apportionment of the parent company's marketing budget, split between the US and Finnish companies on the basis of their respective turnover. The agreement contained a clause limiting the maximum payment by the Finnish company to 1.5% of turnover.

In three consecutive years, the Finnish company paid marketing service charges equivalent to 0.59%, 0.44% and 0.33% of turnover. In return, it had received from the US parent access to a computerised quality control system, advice on the recovery of silver, various services for eliminating equipment defects and functional problems, and training planning services.

Based on the documentation presented, the Supreme Court found that it was necessary to have regard to the price that would have been paid to receive all of the services provided, if they could be obtained, and that it had not been proven that the agreement was on terms different from those that would have been agreed between independent parties. Consequently, the Court overturned the additional assessments submitted by the tax authorities.

Case 1994/1847
A global group operated in 15 European countries in the business of manufacturing electrical fittings and special tools for computer-controlled automated systems. Its Finnish subsidiary imported wholesale products and distributed them in the local market. Under a licensing agreement, the company paid a royalty, based on turnover, to the US resident parent company. The tax authorities took the view that the activities of distributor and wholesaler did not justify paying a royalty. The company argued that the transfer price charged for goods did not take into account the research and development (R&D) costs that the parent incurred and therefore a royalty was justified. The company produced evidence that the lowest price paid by an unrelated dealer for the same products was significantly higher than the intragroup price plus royalty.

The Court considered all of the services, rights and other benefits, enjoyed by the Finnish company, under the licensing agreement and the evidence provided by the company. It concluded that the authorities had not proved that the amount paid by way of royalties based on the principle of cost distribution between group companies was higher than it would have been between unrelated parties, or that the licence agreement contained terms that were not at arm's length. The additional assessments were rejected.

Case 1999/4219
A Finnish parent company had granted its Dutch subsidiary a licence to use its trademark. Under the licensing agreement, the Dutch subsidiary paid the Finnish parent a royalty of 2% of the net income of the group. The Finnish parent also received dividends from the Dutch subsidiary. The Dutch subsidiary had sub-licensed the trademark to other group companies and received a royalty of 5% of the company's net income.

The tax authorities took the view that the terms of the licensing agreement between the Finnish parent company and the Dutch subsidiary were not at arm's length. Their view was that other Finnish group companies had paid a royalty of 5% to the Dutch company in order to enable the Dutch company to pay tax-exempt dividends to the Finnish parent company.

Since the company could not present adequate reasons for the difference between the level of the royalties paid from the Dutch subsidiary to the Finnish parent company and the royalties paid from the other group companies to the Dutch company, the Court held that the Finnish parent company and the Dutch subsidiary had in their licensing agreement agreed on terms that differed from the terms used between unrelated parties. The taxable profit of the Finnish parent was increased by FIM 5 million of the dividends paid by the Dutch subsidiary.

Case 2010/73
The Supreme Administrative Court ruled that the interest rate on an intragroup loan cannot be determined based on the average interest rate on the group's external lending, in the situation where the debtor company's creditworthiness and other circumstances would have made it possible for the debtor company to receive external debt financing at a lower interest rate.

The Finnish company in question had, before a refinancing of the whole group, two separate loans (total value of EUR 36 million) from a third-party financial institution at the interest rates of 3.135% and 3.25%, and collateral given by the company was equivalent to EUR 41 million. At the refinancing, the company repaid its third-party loans and took a loan (EUR 38 million) from a Swedish group company at an interest rate of 9.5%. In addition, the company gave collateral worth EUR 300 million for the benefit of other group companies. The interest rate comprised different interest rates from bank loans, risk loans and loans from shareholders. The average interest rate of the external financing of the whole group was 7.04%.

The Supreme Administrative Court ruled that the interest paid by the Finnish company to the Swedish group company clearly exceeded the amount that would have been paid between unrelated parties. The amount of tax-deductible interest could not have been defined on the basis of the average interest rate of the group's external financing (7.04%) in the case where the creditworthiness of the Finnish company and other

circumstances would have made it possible to receive financing at a significantly lower interest rate. The difference between 9.5% and 3.25% (amounting to a total of EUR 845,354) was considered as non-tax-deductible interest and was added to the taxable income of the Finnish company.

The Supreme Administrative Court's ruling was based on the following grounds:

- The interest paid by the company to the related party clearly exceeded the amount that would have been paid between independent parties.
- According to the information received, the company in question did not receive any financing services from the group's financing company or elsewhere which needed to be considered when evaluating the arm's-length interest rate.
- It was not in accordance with the arm's-length standard to determine the amount of deductible interest by reference to the average interest rate of the external financing of the whole group in a situation where the company's own financial position and other circumstances would have made possible financing at a lower interest.

Case 2013/36
The Finnish parent company had a contract manufacturing subsidiary in Estonia. The Finnish parent company had transferred part of its manufacturing to its Estonian affiliate. The pricing of intragroup contract manufacturing services rendered by the Estonian subsidiary was established by applying the transactional net margin method (TNMM). According to the Finnish parent company, location savings incurred from the manufacturing in Estonia should have been taken into account when determining the arm's-length compensation for the Estonian subsidiary. As a result, when applying the TNMM, half of the location savings were added to the cost base. The company had performed a benchmark study, based on which the contract manufacturing service fee included 7.95% (median of the range) mark-up, added on to actual costs.

The Supreme Administrative Court ruled that in this case, the facts and circumstances did not correspond with the location savings principles described in the OECD Guidelines, since the manufacturing functions performed by the Estonian subsidiary were significantly different from the manufacturing functions previously performed by the Finnish parent company.

However, the Supreme Administrative Court ruled that there were grounds to use higher mark-up when calculating the compensation for the Estonian subsidiary's contract manufacturing functions, due to the fact that the Estonian subsidiary had significant know-how related to the manufacturing process, which would have strengthened the bargaining power of the Estonian subsidiary, if dealing with independent parties. In addition, it had to be taken into account that most of the comparable companies located in the countries in which the level of costs is higher and so, the location of the Estonian subsidiary in the low-cost country allowed the higher mark-up.

Case 2014/33
A Finnish company was part of a Norwegian Group. The Finnish company sold shares in its Finnish subsidiary to a Norwegian company, which was also part of the same group. The Norwegian group company resold the shares in the Finnish subsidiary to another Norwegian group company during the same day by subscribing the shares in another Norwegian group company. In addition to the Finnish subsidiary, some other

companies in the group had been transferred to another Norwegian group company, which was listed in June 2004.

The Finnish company had determined the sales price for the shares in its Finnish subsidiary by using the discounted cash-flow method. The valuation was prepared by a third-party expert.

According to the Supreme Administrative Court's decision, the valuation in this specific case did not reliably indicate the Finnish subsidiary's fair market value. The Court confirmed that valuation should primarily be established from comparable transactions; however, such transactions were not at hand. The Court also acknowledged the discounted cash-flow method as a valid valuation method, but rejected the specific valuation prepared for this case. The Supreme Administrative Court accepted the net assets value as a fair indication for the case and disregarded the lower valuation, based on the discounted cash flow.

The fact that there was a 20% minority shareholding in the listed Norwegian group company in this case was not enough to demonstrate the arm's-length nature of the sales price, nor was the below net asset value share price accepted, due to the fact that the market value of the listed Norwegian group company was below net asset value.

The Supreme Administrative Court ruled that the assessment of approximately EUR62 million made on the Finnish company's taxable income is justified. However, since the Finnish company had tried to establish the market value and since the matter was open to various interpretations, the punitive tax increase of EUR 620,000 imposed by the tax authorities was removed.

Case 2014/119
A Finnish company had received a loan amounting to EUR 15 million from its Luxembourgian parent company. The Finnish company had declared interest expenses of EUR 1,337,500 to be deducted from its business source of income. The granting of the loan was based on a claim for an additional financing contribution by the banks financing the Finnish company, which had to be subordinate with respect to the loans granted by the banks and characterised in the IFRS (International Financial Reporting Standard) financial statements as a so-called hybrid loan and treated as equity. The loan was unsecured and perpetual. The fixed annual interest rate was 30% and the interest was added to the loan capital. The loan could be settled only on the Finnish company's request.

The tax authorities had disregarded the loan arrangement, based on Article 31.1 of the Act on Tax Assessment Procedure and characterised the loan as an equity investment, whereupon the interest was not deductible.

The Supreme Administrative Court considered that the disregarding and recharacterisation of the transaction between the parties would have required – taking into account the consequences of such an arrangement – a specific provision allowing recharacterisation included in the Act on Assessment Procedure. Article 31.1 of the referred Act was not considered to include such an authorisation, whereupon the recharacterisation made by the tax authorities was not acceptable.

In addition, the Supreme Administrative Court considered that the OECD TP Guidelines provide guidance on interpretation only within the area of application of Article 31.1 of the Act, i.e. when determining the arm's-length nature of the terms of the transaction between the parties. Furthermore, the Guidelines were not considered to have an expansive effect on the area of application of the provision of the Act, whereupon the disregarding of the transaction could not be based on the OECD Guidelines.

As a result, the Supreme Administrative Court considered the interest expenses to be tax-deductible.

Comparison with OECD Guidelines

As an OECD member, Finland has approved the OECD Guidelines. The tax authorities follow the OECD Guidelines and other guidance approved by the OECD very carefully. However, issues may arise as to how to interpret the OECD guidance.

38.

France

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Overview

French transfer pricing (TP) rules comply with the Organisation for Economic Co-operation and Development (OECD) TP Guidelines. Moreover, the French TP documentation rules are drawn from the Code of Conduct adopted by the European Union (EU), whereby two levels of information need to be provided to the tax authorities: i) general information on the group of companies, and ii) specific information on the French taxpayer.

Transfer pricing continues to be an area of focus for the French tax authorities (FTA). The French environment has become tougher for taxpayers as the FTA now have new legal grounds to require increased transparency. The 2014 Finance Law introduced several new TP provisions including: i) the obligation to provide both analytical and (if relevant) consolidated accounts during a tax audit, and ii) the obligation to disclose foreign tax rulings in TP documentation, even where these rulings do not directly impact the results of the French company (to the extent they are in the hands of the French company).

The law against 'Fraud and Serious Economic and Financial Crime', dated December 6th 2013, enacted moreover new 'simplified' TP documentation requirements, which concern taxpayers that are within the scope of contemporaneous general TP documentation requirements. The simplified documentation needs to be submitted to the FTA within 6 months of the tax return filing deadline, and is likely to be used by the FTA as a tool to improve the targeting of companies to be audited.

The overall impact of the new provisions will be to increase the FTA's control over TP in the context of tax audits, which follows the trend initiated by the OECD base erosion and profit shifting (BEPS) initiative.

Current hot topics in France presently include cross-border business restructurings, inter-company financing transactions, management fees, royalty payments and situations of losses.

The tax audit procedure provides the possibility to hold negotiations at different levels within the tax administration. Moreover, France has a large treaty network and

the mutual agreement procedure (MAP) is possible with most major trade partners. Consequently, in most cases a settlement is reached through negotiations with the FTA and/or through a MAP without litigation.

Country	**France**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	i) Full scope documentation must be provided upon request during a tax audit; ii) Simplified documentation must be submitted to the tax authorities within six months of the tax return filing deadline.
Must TP documentation be prepared in the official/local language?	No (English is generally accepted but the inspector may ask for a French translation of certain parts or of the entire document.)
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Maximum 5% penalty on the basis of TP reassessments or 0.5% of intra-group transactions if higher, with a minimum of 10,000 euros (EUR) per audited year.

Introduction

Statutory rules on TP adopt the arm's-length principle for cross-border related-party transactions. In addition, many court cases deal with issues relevant to TP, which aids in the interpretation and application of the legislation. In parallel with increased resources within the French Tax Administration (FTA), recent legislative developments emphasise the focus of the FTA on TP issues through new rules for documentation as well as tax measures against tax evasion.

Legislation and guidance

Statutory rules

The following main statutory rules address TP:

- Section 57 of the French Tax Code (FTC) (CGI – Code *Général des Impôts*).
- The concept of '*acte anormal de gestion*' (an abnormal act of management) also allows the FTA to deny tax deduction for expenses that are not related to normal acts of management or could not be deemed to have been incurred for the benefit of the business. The courts decide whether this concept applies by comparing the commercial practices of the company under review with what they judge to be 'normal' acts of management.
- Sections L 13 AA, L 13 AB and L 13 B of the Tax Procedure Code and section 223 *quinquies* B of the CGI, which set out TP documentation requirements.
- Section L 188 A of the tax procedure code, which extends the statute of limitations when the French revenue requests information from another state under the exchange of information clause of the applicable tax treaty.
- The FTA also released a TP guide dedicated to small- and medium-sized enterprises in November 2006.

In theory, the tax authorities may choose whether to apply section 57 or the concept of '*acte anormal de gestion*' when questioning a TP policy. In reality, this element of choice is likely to be removed by the limitations of each regulation.

Section 57 – Indirect transfer of profits

Section 57 was introduced into the FTC on 31 May 1933 and has been regularly updated since then.

Section 57 provides that 'To determine the income tax owed by companies that either depend on or control enterprises outside France, any profits transferred to those enterprises indirectly via increases or decreases in purchase or selling prices, or by any other means, shall be added back into the taxable income shown in the companies' accounts. The same procedure shall apply to companies that depend on an enterprise or a group that also controls enterprises outside France.

For Article 57 to be applicable, the tax authorities must prove:

- That the French undertaking is controlled by or controls a foreign undertaking or that both are controlled by a third undertaking, or by the same group or consortium. If, however, the foreign undertaking benefits from a privileged tax regime (i.e. its tax burden is at least 50% lower than the one that would exist in France), the tax authorities do not have to prove control in order to avail themselves of article 57;
- The Rectificative Finance Law for 2014 has created a second exception to the condition of control within the meaning of Article 57. It states that this condition is not required when the foreign undertaking is established or incorporated in a non-cooperative state or territory (i.e. which refuses international standards for the sharing of tax information, within the meaning of Article 238-0 A of the CGI; for 2014, this relates to Botswana, Brunei, Guatemala, Marshall Islands, Montserrat, Nauru, Niue, British Virgin Islands).

It may be applied only in relation to cross-border TP issues. Enforcement of section 57 requires the tax authorities to prove that a dependent relationship existed between the parties involved in the transaction under review and that a transfer of profits occurred. However, it is not necessary to prove dependency when applying section 57 to transfers between entities in France and related entities operating in tax havens.

Dependency can be legal or de facto. Legal dependency is relatively easy for the tax authorities to prove. It is defined as direct control by a foreign entity of the share capital or voting rights of the French entity under review. It can also mean dependency through indirect control, such as through common management. *De facto* control results from the commercial relationship that exists between two or more enterprises. For example, where the prices of goods sold by A are fixed by B, or where A and B use the same trade names or produce the same product, there does not have to be any direct common ownership. However, the fact that a large proportion of two or more companies' turnover results from transactions conducted between themselves does not necessarily mean that there is de facto dependency. The Tax Administrative Court of Paris ruled on 13 February 1997 that there was de facto control in the following situation: One French company in charge of the distribution of books published by a Swiss corporation was using personnel and equipment provided by a subsidiary of the Swiss entity, had the same management as the Swiss entity and had authority on the choice of books to be distributed.

A transfer of profits may be inferred where, for example, transactions occur at prices higher or lower than prevailing market prices. This includes all types of transactions including commodities, services, royalties, management services or financing.

Acte anormal de gestion

This concept, which derives from section 39 of the CGI, was developed by the *Conseil d'Etat* (CE), the French supreme tax court in charge of corporate income tax issues.

For the determination of taxable income, expenses are tax-deductible only to the extent that they are incurred for the benefit of the business or within the framework of normal commercial management.

To invoke the concept of an '*acte anormal de gestion*', it is necessary to prove that a transfer of profits has taken place and that there was a deliberate intention to move profits or losses from one taxpayer to another. It may be applied to domestic and international transfer prices as well as to corporations or branches.

Under this concept, a tax deduction may be refused for charges not incurred for the benefit of the business or not arising from normal commercial operations.

Other regulations

In addition to the legislation specific to TP described above, the following texts and regulations are relevant to the issue:

- The first pure TP regulation was issued on 4 May 1973, in the form of a note. This regulation is the main element of the FTA doctrine, and in April 1983, the tax authorities finalised and published this commentary on their interpretation of the TP legislation once section 57 was amended to cover transactions with tax havens.

- A regulation published on 23 February 2006, on bilateral and EU MAPs.
- Regulations published on 7 September 1999, on bilateral advance pricing agreements and 24 June 2005, on unilateral advance pricing agreements (APAs).
- The tax authorities' commentary on legal cases involving TP, which has been issued over the years in the form of administrative regulations.
- The terms of various tax treaties.
- Sections of the FTC that deal with related issues such as transactions with entities in tax havens.

Section 238 A limits the deductibility in France of commissions and other payments paid to entities located in tax havens. A company is deemed to benefit from a privileged tax regime when the difference between the foreign corporate tax and the tax that would have been paid in France exceeds 50%.

Under section 209 B, income that is transferred under certain conditions to a controlled foreign company (CFC) or a permanent establishment (PE) which enjoys a privileged tax regime has to be recaptured in France and is subject to corporate income tax. These French CFC rules may not be applied if the foreign company is located in a member state of the EU and if the arrangement in question is not an artificial arrangement set up only to obtain a tax advantage. In its regulations, the FTA makes a reference to the ICI and Cadbury Schweppes ECJ cases to explain the meaning of 'artificial arrangements' mentioned in the EU safeguard clause (BOI-IS-BASE-60-10-40-20120912).

French CFC rules do not apply to foreign-controlled entities that carry on an active trade or business in a non-EU country where they benefit from a privileged tax regime. For fiscal years ending on 31 December 2012 and thereafter, the burden of proof rests with the taxpayers.

Sections of the French Tax Code that deal with specific measures against states or territories considered to be non-cooperative

As from 1 January 2010, section 238 0-A defines, from a French perspective, non-cooperative states or territories (NCST) as a country or territory that:

- is not a member of the EU
- has been reviewed and monitored by the OECD Global Forum on Transparency and Exchange of Information
- has not concluded at least 12 administrative assistance agreements/treaties that allow a complete exchange of information for tax purposes, and
- has not concluded such an agreement/treaty with France.

The NCST list is updated annually to take into account, in particular, the effective implementation of the tax information exchange agreements.

As of 1 January 2014, NCST include the following states or territories: Botswana, Brunei, Guatemala, Marshall Islands, Montserrat, Republic of Nauru, Jersey, Bermuda and the British Virgin Islands.

Withholding tax on passive income is increased to 50% for operations with NCST. Amounts paid to entities located in an NCST may also not be tax-deductible for French corporate income tax purposes.

Interest deductibility

Hybrid mismatch arrangements

The Finance Law for 2014 added a new provision to the existing rules governing interest deductions for financing from a lender that is directly or indirectly related to a French borrower. The French tax authorities released draft guidelines regarding this legislation on 15 April 2014.

Under the new rule, interest deductions are allowed only if the French borrower demonstrates that the lender is, for the current tax year, subject to corporate tax on the interest income that equals 25% or more of the corporate tax that would be due in France.

Thin capitalisation

To counter thin capitalisation situations more efficiently, the French 2006 Finance Law adopted a new system, applicable from January 2007. The scope of the old thin capitalisation rule had been limited by two major decisions of the French Supreme Court in December 2003 (*Conseil d'Etat, Andritz SA* and *Correal Gestion*) and by a regulation dated 12 January 2005.

The 2007 provisions provide for the repeal of the existing thin capitalisation legislation and replacement by an entirely new set of rules, which cover the interest rate charged and thin capitalisation. These new thin capitalisation rules apply to all types of financing granted to a French entity by any French or foreign-related party.

Interest rate limitations

Under the revised Article 212 of the CGI, the tax deduction of interest paid to related parties is limited to the higher of i) the average annual interest rate charged by lending institutions to companies for medium-term (two years or more) variable-rate loans, or ii) the interest that the indebted company could have obtained from independent banks under similar circumstances.

The arm's-length criterion mentioned in ii) is a new feature for France. This provision is likely to shift the burden of proof to the taxpayer, as the French tax authorities, in practice, likely will seek to apply the average annual interest rate. Once companies have passed this interest rate test, French indebted companies must pass a second test, namely the debt ratio.

Debt ratio

In addition, the new thin capitalisation rules provide that a portion of interest paid to related parties, which is deductible under the interest rate test, may be disqualified as a deduction if it exceeds all of the three following limitations during the same financial year:

- Interest relating to financing of any kind granted by related parties within the limit of 1.5 times the net equity of the borrower.
- 25% of the adjusted net income before tax (*'résultat courant avant impôt'*, defined as operating income increased by financial income), before related-party interest, amortisation and certain specific lease payments.
- Interest income received from related parties (there is no limitation on thin capitalisation grounds when the enterprise is in a net lending position vis-à-vis related entities).

The portion of interest that exceeds the above three limits may not be deducted in the accounting period unless it amounts to less than EUR 150,000.

For these purposes, 'related parties' are defined as i) a parent company and a subsidiary whose capital is held more than 50%, directly or indirectly, by the parent company, or which is de facto controlled by the parent company, or ii) two companies that are controlled, directly or indirectly, by a common parent company.

The 2010 Finance Law brought all financings (including bank loans) secured by a 'related party' within the scope of the thin capitalisation limitations. Therefore, any financing in respect of which a related party grants a guarantee or security is treated as related-party debt.

Carry-forward of excess interests
That portion of the interest expense that is not immediately deductible by the French enterprise in the accounting period in which it is incurred may be carried forward without a time limit for relief in subsequent years, provided that there is excess capacity in the subsequent years, based on the second limitation mentioned above. However, the excess amount is reduced by 5% each year, from the second accounting period following that in which the interest expense was incurred.

Exceptions
The new provisions provide for several exceptions.

These new rules do not apply to interest payable by banks and lending institutions, or to certain specific situations (e.g. interest in connection with intragroup cash pools or in connection with certain leasing transactions).

In addition, the thin capitalisation rules do not apply if the French indebted company can demonstrate that the debt-to-equity (D/E) ratio of the worldwide group to which it belongs exceeds its own D/E ratio.

Also, deductibility of interest is facilitated within a French tax-consolidated group. The new thin capitalisation rules apply to each enterprise member of the group taken on a standalone basis.

However, any excess interest incurred by such an enterprise may not be carried forward by that enterprise. Instead, it is appropriated at the group level. Subject to certain limitations, the consolidating company may deduct extra 'disqualified' interest. Any remaining excess interest may be carried forward for possible deduction at the group level in future accounting periods, less the 5% rebate.

The FTA issued an administrative regulation regarding these new complex rules on 31 December 2007. The guidelines provide the French tax authorities' interpretation of section 212 of the FTC relating to thin capitalisation rules. They clarify the legal provisions and provide practical guidance on the computation of the three tests.

In particular, the guidelines state that section 212 is applicable to PE of foreign companies. It provides clarification on how the D/E ratio would be applied in the case of PEs where the entities do not have a share capital, *per se*.

The guidelines also detail the exclusion of 'treasury centre' and 'leasing agreements' from the scope of the thin capitalisation rules, and they describe the specific conditions under which the thin capitalisation rules would allow deduction at a tax group level (section 223B of the FTC) for those interests that have failed the three tests at the level of a subsidiary on a standalone basis.

'Carrez amendment'
On 1 January 2012, new tax rules entered into force with regard to the deductibility of interest and other expenses from share acquisitions (section 209 IX of the FTC).

Under this new legislation, the deduction of interest expenses incurred in France by a company for purposes of the acquisition of shares qualifying for the French participation exemption regime is subject to restrictions, unless the French acquiring company can prove that the decisions relating to such shares are being taken by it and where the group exercises control (or influence) over the acquired company; such control (or influence) is exercised by the French acquiring company or one of its affiliates, established in France.

If the French company fails to provide such evidence, the company owning the shares is required to recapture a part of its financial expenses incurred during each financial year running over the eight-year period following the year during which the acquisition took place. This rule applies retroactively to acquisitions made as far back as 2004, but deductions' disallowances can be applied only starting from a company's 2012 fiscal year.

General interest deduction limitation rule
Under a new limitation on interest deduction for companies subject to corporate income tax in France, 15% of net financial expenses of a company are no longer deductible in 2013 (25% as from 2014). The net financial expenses are defined as the total amount of financial expenses incurred as a consideration for financing granted to the company by any other entity (third party or related), reduced by the financial income received by the company in consideration for financing granted by the latter.

A 'safe harbour' has been introduced to prevent the application of this limitation when the total amount of net financial expenses of a company does not exceed EUR 3 million. The calculation of this threshold excludes the interests that are not deductible according to sections 209 and 212 of the French Tax Code (FTC). The limitation applies as from the first euro of net financial expenses exceeding EUR 3 million and the tax is paid on the entire amount (i.e. not limited to the amount exceeding the threshold). This is a permanent disallowance as there would be no carry-forward mechanism for the disallowed interest.

In April 2014, the French revenue issued a regulation regarding the order in which interest deductibility rules should apply.

Penalties

Specific penalties on transfer pricing
If the complete documentation is not provided or incomplete, a maximum penalty of 5% of the assessed amount, or of 0.5% of intra-group transactions if higher (regarding this second point, for tax audits which started as of 1 January 2015), will apply in respect of transactions not documented. The minimum penalty will be EUR 10,000 per fiscal year audited. There would also be a risk of arbitrary reassessments.

Additional tax and penalties
Interest at the rate of 0.40% per month, or 4.8% per year, is charged for late payment or underpayment of corporate income tax. These amounts are not deductible for the corporate income-tax basis.

If the good faith of the entity is challenged, which tends to be frequent when TP issues are scrutinised, a penalty of 40% or even 80% of the tax avoided is levied (*pénalités pour manquement délibéré*). This extra charge is obviously not deductible from the corporate income-tax basis.

In addition, a TP adjustment may lead to adjustments relating to VAT or CVAE (*cotisation sur la valeur ajouée des entreprises* or corporate tax on business added value), as well as a deemed dividend issue, depending on treaty provisions.

Documentation

Section L 13 AA – Transfer pricing completes documentation requirements
The Amended Finance Act for 2009, passed on 31 December 2009, introduced into French law requirements for TP documentation. Following the adoption of the documentation requirements, the FTA released specific guidance to clarify the TP documentation law. The general TP documentation requirements apply to tax years beginning on or after 1 January 2010 to any one of the following types of entities located in France:

- With turnover or gross assets on the balance sheet exceeding EUR 400 million.
- That holds directly or indirectly more than 50% of capital or voting rights of a legal entity mentioned in first bullet (above).
- With more than 50% of their capital or voting rights held directly or indirectly by a legal entity mentioned in first bullet (above).
- That benefit from a ruling granting a worldwide tax consolidation regime.
- That are part of a French tax group in which at least one legal entity of the tax group meets one of the requirements mentioned under each of the above bullet points.

The regulations state that the PEs are also within the scope of the TP documentation requirements.

The law requires formal and compulsory TP documentation, which must include the following information:

- General information on the group:
    - General description of the activity including changes occurred during the audited years.
    - General description of the legal and operational structures forming the group identifying the related companies engaged in the intragroup transactions.
    - Description of the functions performed and of the risks borne by the related companies to the extent they have an impact in the audited company.
    - Identification of main intangible assets having a link to the audited company (e.g. patents, trademarks, trade names, know-how, etc.).
    - Broad description of the TP policy.

According to the administrative regulations, such general information should allow the FTA to understand the economic, legal, financial and fiscal environment of the group. The main entities of the group must be presented, with a level of detail depending on the importance of their activity within the group, but also depending on how much their functions and assets impact the group's TP policy.

- Specific information on the audited company and on the TP policy. In particular, the following elements should be provided:
  - Description of its activities including changes that took place during the audited period.
  - Information on operations carried out with related parties including nature and amount of flows (global flows per category of transactions; this covers royalties in particular).
  - List of cost-sharing agreements, APAs and rulings obtained, having an impact on the results of the company.
  - Description of the TP policy with an explanation on the selection and application of the retained method, in compliance with the arm's-length principle and with the analysis of the functions performed, of the risks borne and of the assets used by the audited company.
  - Where relevant, an analysis of the comparability elements taken into account in the application of the retained TP method.

According to the regulations, such specific information should allow the FTA to assess whether the TP policy applied is compliant with the OECD's arm's-length principle.

The audited company may also provide any other relevant documents.

The complete set of documentation should be maintained and provided immediately upon request (which could be the first day of a tax audit). The regulations, however, provide for a 30-day extension if the documentation is not available or incomplete, with a possible additional extension of 30 days.

Therefore, it is advisable for companies within the scope of the new regulations to maintain contemporaneous documentation in anticipation of tax audits considering the stricter deadlines and penalties.

Companies outside the scope would remain subject to documentation requests during tax audits. Even if penalties are lower and deadlines not so strict, these companies would still be at risk of arbitrary reassessments for not having TP documentation in place.

Section 223 *quinquies* B – Simplified transfer pricing documentation requirements

The Law relating to 'Fraud and Serious Economic and Financial Crime' dated 6 December 2013, introduced a second set of simplified TP documentation requirement, applicable to companies that fall within the scope of section L.13 AA of the tax procedure code.

The simplified documentation shall be provided to the FTA within 6 months of the tax return filing, and shall include the following information:

- General information on the group:
  - General description of the activity including changes occurred during the audited years.
  - Identification of main intangible assets having a link to the audited company (e.g. patents, trademarks, trade names, know-how, etc.).
  - Broad description of the TP policy including changes occurred during the audited year.
- Specific information on the audited company:
  - Description of its activities including changes occurred during the audited period.
  - List of transactions carried out with related companies, by nature and amount, when the total amount per nature of transaction exceeds EUR 100,000.
  - Presentation of the method(s) applied to set transfer prices under the arm's-length principle mentioning the main method and the changes occurred during the audited year.

The simplified TP documentation requirement applies to tax returns for which the filing deadline is on, or after, 8 December 2013.

Section L 13 AB
Operations that are conducted by French companies with an associated entity situated in a non-cooperative state or territory are subject to an additional documentation obligation. The French company must notably provide the financial statements of the associated entity.

Section L 13 B
Section L13 B applies mainly to small- and medium-sized businesses (SMBs) not part of a large group (companies not within the scope of the above-mentioned section L13 AA). The Economic and Financial Act, published on 13 April 1996, contains procedures for TP examinations. This legislation gives the FTA a clear right to request information on the taxpayers' TP policy in the course of a tax examination when it has evidence upon which to presume that an indirect transfer of profits abroad has occurred, as defined by section 57 of the FTC. This procedure applies only in the course of a normal examination.

Four types of information may be requested under this procedure:

- The nature of the inter-company transactions.
- The method for determining prices for transactions.
- The activities of the foreign enterprises, companies or joint ventures.
- The tax treatment of the inter-company transactions.

Requests shall include a notification of the expected response time to the audited enterprise. The time allowed for response, which shall be no less than two months, may be extended upon justification to a total of no more than three months.

If an enterprise has responded inadequately, the administration may demand additional information within 30 days with a formal notice. This notice shall specify the desired additional information and mention the penalties in case of non-response. Thereafter, the sanctions imposed on the taxpayer will be twofold:

- A EUR 10,000 fine for each period under audit.
- The right for the FTA to reassess the taxpayer's profits on the basis of the information at its disposal. (This procedure, however, remains controversial. The burden of proof of the dependence and of the non-arm's-length character of the transactions rests with the FTA.)

On 23 July 1998, the FTA published a regulation commenting on the provisions of section L13 B. This regulation specifies in particular that resorting to section L13 B is neither obligatory nor systematic – it takes place only if the tax inspector has not been provided with sufficient explanations during the tax audit.

Regarding the TP method used, any method invoked by the enterprise can be considered acceptable, provided that it is justified by contracts or internal memos describing the method, extracts of the general or analytical accounts, economic analyses (notably on the markets), the functions fulfilled, the risks assumed and the comparables retained. The FTA still broadly interprets elements required to justify the TP method.

Transfer pricing controversy and dispute resolution

Legal cases

Several cases over the years have established important principles for dealing with TP issues. These are summarised below:

Parent-subsidiary relations: expenses invoiced by a foreign parent company
SA Borsumij Whery France, CAA (*Cour Administrative d'Appel*) Paris 11 February 1997
The administration considered that the reimbursement of such a charge represented a transfer of profits abroad 'insofar as the French company has not substantiated the reality of the services, invoiced in a vague manner for services which the French company could perform itself'. The submission of 'incomplete documents of a general nature' was deemed to be insufficient. This analysis was then confirmed by the French Supreme Tax Court.

Parent-subsidiary relations: partnership
SA Cogedac, CE 23 November 2001
A parent company and its subsidiary incorporated a partnership in which the subsidiary contributed its purchasing platform. Ninety percent of the benefits were attributed to the parent company. In the absence of a significant contribution from the parent company to the activity of the partnership, and considering the lack of commercial interest for the subsidiary to enter into the partnership convention, the *Conseil d'Etat* ruled that the conclusion of the partnership convention by the subsidiary was constitutive of an abnormal act of management.

Reality of services
SA Bossard Consultants, CAA Paris 17 March 1998
A subsidiary company, which paid royalties for a licence of a trademark to its parent company, could not deduct part of the sums paid as a temporary increase of the royalties by one point because it could not justify the reality of the public relations and promotion activities in respect of the trademark that the temporary increase was purported to cover.

Date to use when appraising a transfer pricing transaction
CE Ford France 16 March 1990 and CAA Paris 4 October 1994
The transaction must be appraised on the basis of facts known (or facts that could have reasonably been known in the circumstances) at the time the contract was made. The use of hindsight is not permitted.

Comparable searches
Société Pharmatique Industrie, CAA Paris, 12 July 1994; CE Galerie Vercel, 28 September 1988; SARL Solodet, CE, 21 February 1990; Reynolds Tobacco, CAA Paris, 20 November 1990; Lindt et Sprungli CE, 4 December 2002; Novartis Groupe France SA, CAA Paris, 25 June 2008; Man Camions et Bus, CAA Versailles, 5 May 2009; Microsoft France, CAA Versailles, 16 February 2012; Eduard Kettner, CAA Paris, 29 March 2012; CAA Versailles 12 June 2014 n°03317; CAA Versailles 8 July 2014 n°11VE01187
The Pharmatique Industrie case illustrates the type of comparison that the courts require from the FTA and taxpayers. The tax authorities used five products of similar commercial reputation, distributed by three companies operating in the same pharmaceutical sector with comparable turnovers, as comparable evidence in a TP dispute.

The CE is very careful when examining comparable situations. For example, the CE, on 28 September 1998, refused to consider that situations were comparable when the FTA was relying on isolated French-based transactions when the situation under audit involved a long-lasting relationship between a French entity and its US subsidiary.

In Solodet, the comparison was rejected because the comparable products were sold in Germany rather than in France. It was judged that both the prevailing market conditions and the end-use of the products in Germany were different, and that therefore the companies identified by the tax authorities were, in fact, not comparable to the French company under review.

In Reynolds Tobacco, the 2%–3% commission received by the French entity was deemed by the courts to be an arm's-length amount, even though competitors were receiving about 8% for providing similar services. This was decided on the basis that the services provided by the French company were sufficiently, if only slightly, different, and this justified the lower rate charged.

In Lindt & Sprungli, the CE approved the position taken by the FTA, even though the FTA did not support its position by reference to independent comparable data, but rather through facts and circumstances of the case at stake.

In the Novartis Groupe France SA case, the court stated that if the FTA intends to use prices existing between other companies or a profit split approach by considering the global margin realised on one product at group level to reassess the French entity, it

must demonstrate that the price invoiced to the French entity by a related company does not comply with the arm's-length principle with a relevant and exhaustive economic analysis. In this case, the court notably criticised the fact that the FTA did not perform a comparable search.

In Man Camions et Bus, the Court of Appeals stated that a comparability study performed by the FTA has to be based on independent comparables acting in similar conditions and markets. In this case, the FTA did not establish that foreign European markets were similar to the French market and therefore rejected the pan-European comparable study performed by the FTA. The fact that the French entity has been loss-making for years is not, in isolation, sufficient to prove the existence of a transfer of benefit out of France.

In the Microsoft case, the distribution activity of a French subsidiary of an American group was transferred to its Irish sister company. The French subsidiary was then converted into the sales' agent of the Irish subsidiary. The Commission rate earned by the French subsidiary was reduced from 25% to 18%. The French tax authorities, taking into account the previous 25% commission rate, considered that it should not have been reduced and reinstated the corresponding income into the French company's taxable income. To support their position, the French tax authorities conducted a benchmarking study. However, the Court of Appeals ruled that the mere fact that the commission rate has been reduced does not demonstrate the transfer of profits abroad. Moreover, the Court confirmed that the transfer of profits abroad was not proved, due to the irrelevance of the methods used and of the comparables found by the French tax authorities. The companies were not suitable for comparison because they were not in the same market as Microsoft France and that some of them were not independent companies.

Regarding the provision of intragroup services, in the Kettner case, the Paris Administrative Court of Appeals considered that, in order to demonstrate a transfer of profits abroad, the French tax authorities have to make a comparison with independent companies in order to show to what extent the fees paid for the services did not meet the arm's-length principle.

In two other cases (CAA Versailles 12 June 2014, No.11VE03317 and CAA Versailles, 8 July 2014, No.11VE01187), the FTA based its reassessments on comparable studies to determine, in the first case, the level of net margin that should have been earned by the company, and in the second case, the level of royalty payments the taxpayer should have received. In both cases, the Court considered the comparables provided by the FTA were not relevant (pointing out in particular differences of market or of activity, or dependence).

Concept of group interest

CE, 24 February 1978, n° 2372; Sovifram, CE 3 June 1992; Société Nord Eclair, CAA Nancy, 6 March 1996; SA Rocadis, CE 26 September 2001

The French courts consistently have supported the tax authorities in refusing to accept the idea of the interests of the group as a whole serving as sufficient justification for a particular intragroup TP policy. However, charges at cost were accepted by the courts when the charges were invoiced by a parent entity to a subsidiary, according to the 24 February 1978 CE decision.

In the 1992 decision, the CE ruled that selling at a loss, imported wines by a French subsidiary to its foreign parent company is constitutive of an abnormal act of management if the French company does not obtain any counterparty. The mere facts that the French subsidiary was its parent company's exclusive provider or that the French subsidiary benefited of its parent company's clientele was not deemed to constitute a sufficient counterpart.

In a 6 March 1996 decision, the Nancy appeals court expressly accepted an invoicing of charges at cost between two sister entities. This conclusion may derive from the fact that the FTA was challenging the flow of invoices and suggested that the invoicing should have gone through the parent company, so that the loss would have been incurred by the parent entity rather than one of the sister entities.

In the Rocadis decision in 2001, the CE accepted the concept of group of interest between the members of a distribution network. The CE did not adhere to the general group concept approach, but the French court reckoned with the specificity of functioning of this specific distribution network.

Economic or commercial benefit
Boutique 2 M, CE 27 July 1988; CAA Nancy, SAS Mc Cormick France, 8 December 2011
In a number of cases over the years, the courts have accepted taxpayers' arguments that their transfer prices satisfied the arm's-length principle, because even if they were at first sight higher or lower than what would have been expected (i.e. standard market prices), they resulted in some economic or commercial benefit for them; for example, their prices increased market share.

For example, in the SAS Mc Cormick France case, products were sold by a French company to a related-foreign company at a price lower than the market price and the manufacturing cost. The court considered that there was no counterpart in a situation where the considered company could not justify the alleged new clients brought by the group, free loans and financial contributions received from the group.

In all instances where this argument is put forward, the deemed benefit must be specific and reasonable in relation to the loss or reduced revenue recognised by the French company. Where the taxpayer has been able to prove only a potential benefit, the TP policy has been adjusted.

In such cases the burden of proof lies with the taxpayer. Various court decisions have established that this applies whether the tax authorities are attempting to enforce section 57 of the tax code or the concept of 'acte anormal de gestion'.

Legal protection of the intangible licensed as royalty payment
Bentone Sud, CAA Paris 15 June 1999
Despite the fact that the patents were no longer protected and there was a lack of actual transfer of know-how, the Appeal Court of Paris accepted the deductibility of a licence fee covering patents and know-how, in addition to a trademark and a regular supply of equipment. The Court judged that the access to the trademark and the right to access products made by the licensor were a valid justification for the payment of royalty. This decision is unique.

Decisions such as the above-mentioned Lindt & Sprungli confirmed that the lack of legal protection is a critical factor for the courts in appraising the arm's-length nature of a royalty flow.

Existence of a written agreement
Electrolux, CE 23 October 1991; Barassi, CAA Lyon 1 February 1995
The Court ruled in Electrolux that the lack of a written agreement signed prior to transactions taking place was not relevant to the TP policy under dispute because the ongoing trade between the related companies under review supported the transfer price as described to the tax authorities.

Once an agreement has been signed, the parties must abide by it. If circumstances change and the terms no longer apply, it must be amended.

Despite the above court decision, a contemporaneous written agreement is advisable in all instances.

Sale of assets
N°17055, CE 21 November 1980; Berri Ponthieu, CE 21 June 1995
In Berri Ponthieu, the court decided that the sale of shares in a listed entity at book value, which was lower than the prevailing market value, was a non-arm's-length transaction, even though the sale was a group reorganisation.

Similarly, the acquisition of shares at a price exceeding the market value is also a non-arm's-length transaction, unless there are special circumstances.

Sale of goods or services
SARL Rougier-Hornitex, CE 26 June 1996; SNAT, CE 31 July 1992; Rouleau, CAA Bordeaux 27 December 2001; Etablissements Georges Legros, CAA Lyon, 29 October 2010; SAS Unilever France, CAA Versailles, 5 December 2011; Nestle Entreprises, CAA Versailles, March 27, 2012
The sale of products or services to related parties at a price below prevailing domestic or international prices is not considered an arm's-length transaction.

In Rougier-Hornitex, the CE decided that a sale at a loss of services by a subsidiary to a parent company during the subsidiary's first two financial years was not an abnormal act of management. The price of the services, even though generating operating losses, was not below the market price and therefore was considered an arm's-length transaction.

In the Rouleau case, the court ruled that the tax authorities did not establish an 'acte anormal de gestion' by only referencing that the sales of goods and services were below the market price of incomparable products and below a cost price determined retrospectively and including charges linked to the fact that the company was working at under-capacity.

In the Etablissements Georges Legros case, the Court of Appeals decided that setting an intragroup currency conversion rate different from the market rate can constitute a transfer of profits as defined by section 57 of the FTC if it results in a price increase. In this case, such an increase in the prices was not justified by economic reasons.

In the SAS Unilever Case, a French manufacturing company was remunerated on a cost-plus basis. The company, which was in a situation of under-activity, invoiced to a foreign-related company not its actual costs (higher than for other factories of the group), but lower theoretical costs corresponding to a possible more efficient functioning. It has been judged that the resulting negative margin did not justify a reassessment. The judge considered that the French tax authorities did not prove that the transfer prices were not market prices.

Recently, the Versailles Administrative Court of Appeals ruled against the taxpayer in the following case. A French affiliate sold mineral water to a Japanese-related company. The TP method resulted in a net margin of 33% for the Japanese-related company, deemed to be too high by the French tax authorities. They took into account the fact that in Japan, a bottle of mineral water distributed by the Japanese-related company was sold to end-customers at a EUR 2.5 price while the highest market price in a country where the related distributor recognised a routine 6% margin was EUR 0.78, i.e. 3.2 times lower; the net margin in Japan should have been limited accordingly to 6% times 3.2, i.e. 19% according to the French tax authorities. The taxpayer argued that the Japanese-related company was not a routine distributor, but a co-entrepreneur. The Court however considered that it did not bring enough evidence for such as statement, and the TP adjustment was confirmed by the Court.

Commission

CE, 26 June 1985 n°39049 and 29805; Vansthal France, CAA 11 March 1993

A number of court decisions address situations where companies used related intermediaries whose activities did not justify the level of commission or remuneration paid to them. For example, the decision of the Court of Appeal in Nancy on 11 March 1993 disallowed a TP policy under which a 20%–40% markup was added to payments to a Swiss entity, because in its capacity as a billing centre, it bore no risk.

However, where taxpayers have been able to justify the nature and value of the services provided, the courts have invariably accepted the commission paid. For example, a 5% commission was found to be acceptable between A and B, where B was assisting A with promoting its exports to Italy (CE 26 June 1985).

Royalties

Caterpillar, CE 25 October 1989 ; Cap Gemini, CE 7 November 2005; CAA Versailles 18 February 2014, n°11VE03460

In Caterpillar, a 5% royalty was judged to be an arm's-length rate for the manufacturing and assembling operations. In this case, the court refused to accept that there should be different rates for the two different activities.

In Cap Gemini, the French tax Supreme Court stated that the FTA did not demonstrate the indirect transfer of benefit in the absence of a comparability study. The criticised transaction consisted of a royalty-free licence of the Cap Gemini trademark and logo. The Court considered that the fact that French subsidiaries were charged with a 4% royalty, whereas European and American subsidiaries were charged no or lower royalty, was not relevant. The Court considered that the value of a trademark and logo may differ depending on each situation and market. Different situations may request different royalty rates. In its ruling, the CE reaffirmed that a TP reassessment must be based on solid evidence.

In another case (CAA Versailles, 18 February 2014, No. 11VE03460), the FTA disallowed the trademark royalty paid by a company, arguing that such a trademark was not useful in view of the costs incurred and the low amount of related sales. The Court considered that the FTA did not prove the relevance of its different statements in this respect.

Commissionaires

Zimmer Limited, CAA Paris 2 February 2007, CE 31 March 2010

In Zimmer Limited, the Administrative Court of Paris stated that a commissionaire of a UK principal company constituted a permanent establishment (PE) of that company in France. The French company, Zimmer SAS, distributes the products for Zimmer Limited in France and was converted into a commissionaire (acting in its own name but on behalf of Zimmer Ltd.) in 1995. The FTA considered that Zimmer SAS constituted a PE of Zimmer Limited in France because the French entity had the power to bind its UK principal in commercial transactions related to its own activities. Zimmer Limited should, therefore, be taxed on the profits generated in France according to section 209 of the FTC and Article 4 of the double-tax convention between France and the United Kingdom.

The Court concluded that Zimmer SAS constituted a PE of Zimmer Limited in France and that, accordingly, the taxation in France of the profits attributed to such PE for the years under audit was fully justified.

Following the conclusions of the 'Rapporteur public', Ms. Julie Burguburu, the High Court (CE 31 March 2010) nullified the earlier decision of the Paris court and agreed with the taxpayer. The High Court reconfirmed that a company has a PE in a state if it employs a person who has the authority to bind the company in a business relationship and that person is not independent vis-à-vis the company. Two criteria, therefore, need to be met in order to be qualified as a PE. The two criteria are dependence and the authority to engage.

The High Court does not address the issue of dependence, which was not debated in this case because the dependency was already established.

Concerning the authority to engage, the High Court quotes article 94 of the Commerce Code included in article L-132-1 of the new code and notes that the commissionaire acts in its own name and cannot conclude contracts in the name of its principal. It underlines that the commissionaire does not legally bind its principal because of the nature of the contract. The High Court concludes that a commissionaire cannot constitute a PE of the principal. However, the High Court also sets certain limits by stating that when it derives from either the terms and conditions of the commissionaire's contract or any element identified during the examination of the case that the principal is personally bound by the contract agreement concluded by the commissionaire with third parties, and the commissionaire then constitutes a PE of the principal.

Fortune Brands International Holding France, CAA Versailles, 12 June 2014

Regarding the question of the transfer of *clientele* upon conversion of a full-fledged distributor into a commissionaire, the Administrative Appeal Court considered that there was no transfer of *clientele* as the considered *clientele* for which the company acted as a commissionaire (distinct from its own *clientele*) was attached to the products of the trademarks belonging to the foreign principal.

Cross-border business restructuring

Sociétè Nestlé Finance International LTD, TA Paris, 11 May 2011; Société Serapid France, 24 September 2013

In the Nestlé case, a French company transferred its cash pooling activity to a related Swiss entity. The cash pooling function had been purely administrative, carried out exclusively for the benefit of parties related to the French company. The French company did not receive any compensation for the transfer of the cash pooling activity. The administrative court concluded that the transfer of an internal administrative function to a foreign entity – even if the function only involved other affiliated companies 'captive clientele' – required the payment of arm's-length compensation.

This decision has been appealed and has been superseded by a subsequent decision of the Administrative Court of Appeal. The Court of Appeal concluded that the Administration did not bring the necessary evidence that a transfer of profits abroad took place. It stated indeed that the comparables on which the Administation's position was based were not relevant. The Court of Appeal did not however challenge the fact that a payment was due, which still leaves room in future for the Administration to claim an exit tax payment in case of a transfer of functions.

In the Serapid France case, the Administrative Court of Appeal concluded that the transfer of clientele to a foreign company without financial compensation was an abnormal act of management.

Financial charges and revenue

Interest charges

CE, 16 November 1988 n° 75420 and n° 77533; Société Arthur Loyd, CAA Paris 1 February 1994; Montlaur Sakakini, CAA Lyon, 25 October 1995; SNC Immobilière GSE, CE, 7 September 2009; France Immobilier Groupe, CAA Paris, 29 September 2009; Société d'acquisitions immobilières, CE, 22 January 2010.

The interest rate charged to a subsidiary by a French entity must be comparable with the interest rate the French entity would receive from a third-party bank for an investment similar in terms and risk. The interest rate used by the courts as a reference in Montlaur Sakakini is the rate that the lender could have obtained from a third-party bank.

In the France Immobilier Group decision, the Court of Appeal considered that the level of the interest rate should not be assessed by reference to the debts contracted by the lender, but should be based on the financing conditions that the lender could have obtained from a third-party bank.

In the Société d'acquisitions immobilières decision, the High Court decided that the cash advance granted by a sub subsidiary to its 'grandmother' in difficulty with which it had no business relations, even accompanied by the payment of interest, could constitute an abnormal act of management if the amount lent is clearly disproportionate to the creditworthiness of the borrowing company.

In practice, when an interest rate has to be set up, reference should be made to the rate that would be obtained by the borrower (standalone approach), which is in line with the rules set by Article 212 of the FTC (*see below*).

Deferral of payments

Baker International, CAA Bordeaux, 6 April 1994

Payment deferral: If interest is not charged in respect of deferrals of payments granted to a related company, it is considered either an abnormal act of management or is subject to section 57 of the tax code.

Absence of charges for guarantees

Soladi, CAA Nancy 30 April 1998; Carrefour, CE, 17 February 1992

It is deemed to be an abnormal act of management to provide an explicit financial guarantee free of charge, unless direct actual benefit for the entity providing this support can be justified. In a decision of 17 February 1992, the French Supreme Court considered as arm's length a rate of 0.25% for this service, while the FTA was seeking 1%. The remuneration asked for this service should be commensurate with the risk incurred as well as with the market value of this service, irrespective of the actual cost.

Debt waivers

SA Les Editions JC; CE 11 February 1994; Télécoise, CE, 16 May 2003; Guerlain, CE, 23 April 2008; Beauté Créateurs SAS, CAA Paris, 12 May 2010; Société Générale, CAA Versailles, 29 June 2010; Delpeyrat Chevalier, CAA Bordeaux, 15 March 2011

The arm's-length principle also applies to debt waivers. France-based entities may waive all or part of outstanding loans to related foreign entities to the extent that they can justify some own benefit as a result of this financial assistance.

In Télécoise, the High Tax Court determined that a French company is allowed to deduct a provision for bad debt in relation to its foreign branch whenever the debt is related to its foreign business operations carried out through the branch. However, the French company must establish that the operation has a direct commercial benefit on the business activities carried out in France.

In the Guerlain decision, a French company waived its receivables towards two foreign branches in Australia and Singapore of its Hong Kong subsidiary. The judge made a reference to the consolidated results of the subsidiary (including those of the two branches), which were positive despite the financial difficulties of the branches; this was one of the arguments put forward by the judge to reject the deductibility of the waiver of the receivables in France.

In the Beauté Créateurs SAS case, the Court of Appeals applied the principle settled in the Télécoise and Guerlain cases. In this case, the Court permitted the deduction of the debt waiver granted to its foreign branch by the headquarters in France because the branch provided services for the benefit of the French headquarters which increased the sales in France and so developed the business in France.

In the Société Générale case, the parent company granted an advance to a foreign subsidiary to face its financial difficulties and to meet the capital ratio requirements demanded by the local authority. The parent company granted a debt waiver to its subsidiary. The Court ruled that such a debt waiver of a financial nature did not constitute an abnormal act of management if it allowed the parent company to avoid suffering a negative impact on its reputation from the bankruptcy of its subsidiary, even where the subsidiary in question is a small one.

In the Delpeyrat Chevalier case, in order to refuse the deductibility of the debt waiver, the Court of Appeals took into account the turnover generated by the operations conducted with the foreign subsidiary, which was very limited.

Choice of the financing mode of a company's operations
Unicrédit Banca Di Roma, CE 11 April 2014 and Société Caixa Gal. de Depositos, CE 11 April 2014
Article 57 of the FTC does not provide the administration with the authority to assess the 'normal' nature of the choice made by a foreign company to finance the activity of its French branch through debt rather than equity and refuse the deductibility of related interest charges.

This is confirmed by the two decisions of the Supreme Court dated 11 April 2014, where it stated that the FTA does not have the authority to decide whether a branch is to be financed through debt or equity.

Allocation of charges
N° 2372, CE 24 February 1978; Société Office Dépôt France SNC, TA Montreuil, 5 January 2012
Management charges must be shared among all of the group entities, benefiting from the corresponding services. Not allocating charges among all receiving group companies is considered to be an 'acte anormal de gestion'.

Management charges should generally be allocated on the basis of a detailed analysis, taking into account which of the services the company received. However, when such a breakdown would be a cumbersome exercise unlikely to result in an accurate allocation, the charges may be allocated on the basis of a less detailed calculation, such as turnover.

In the Société Office Dépôt France SNC case, a US company recharged to its French subsidiary a portion of audit costs relating to a report meant to check the efficiency of internal control within the group, in compliance with the Sarbanes-Oxley legislation. The judge considered that such costs were incurred in the interest of the US company only, and were accordingly not tax-deductible in France.

Justifying the services
Gibert-Marine, CAA Bordeaux 12 December 1995; Société Labouchède, CE, 22 June 1983; SA Mat transport, CAA Nancy 5 July 2001
The basis of fees paid for management services will be examined in a tax audit. The taxpayer will have to provide evidence about the nature, content and value of the services rendered by the supplier to justify the fees paid and to receive a tax deduction for them. In this context, an invoice alone is not sufficient proof.

Payments for seconded executives
CE, 30 March 1987 n°52754; Oudot Ministerial commentary, 7 September 1987
It was considered that the costs of an executive seconded from a French company to a Swiss subsidiary should be charged to the Swiss company, unless the French entity could demonstrate a commercial or economic benefit from not doing so.

Burden of proof
As a rule, the burden of proof lies with the tax authorities, unless the transfer of profits concerns a tax haven, in which case the burden of proof is transferred to the taxpayer.

However, there is now a legal requirement for taxpayers to provide documentation supporting their TP policies. In practical terms, the burden of proof has always fallen on the taxpayer where the tax authorities have deemed a profit shift to have taken place or inappropriate TP to exist, although in theory the burden of proof lies with the tax administration.

Tax audit procedures

Selection of companies for audit

Generally speaking, transfer prices are audited as part of a formal tax audit on all issues. There are no rules as to which companies come under investigation. Major companies are audited every three to four years, unless they are in a loss-making situation. Nowadays, almost all sectors are audited including French wholly owned entities and subsidiaries of non-France-based groups. It is likely that the new simplified TP documentation to be remitted annually will be used by the FTA to target companies to be audited.

The audit procedure

Tax audits are generally carried out through the following procedure:

- Written notice is sent to the taxpayer informing of the date of the auditor's first visit and the particular taxes and years under investigation. The taxpayer may use a professional adviser to assist during the investigation.
- The auditor's site visits take place at the taxpayer's main premises, either the registered offices or the main place of operations. The auditor's onsite presence can last from a few days to several months, depending on the size of the taxpayer's business and the number and complexity of issues under review. There is no maximum limit to the time the auditor may spend onsite. The auditor may be assisted by information systems or specialists taken from a dedicated group within the tax administration, as well as by FTA TP experts.
- Throughout the auditor's visit(s), regular dialogue takes place between the taxpayer and the tax inspector.
- Onsite investigations by the tax inspector cease when the inspector is satisfied that all outstanding questions have been answered. At this point, written notice of any underpayment is sent to the taxpayer.
- The taxpayer must provide a written response to the notice within 30 days of receipt. In the response, the taxpayer must either accept or reject the proposed adjustment. If they choose to contest the reassessment, the taxpayer must set out detailed and convincing arguments to support their case. At this point, the taxpayer may ask to meet the tax inspector's superior. Such a request is generally not denied. After this meeting the taxpayer may then also request a meeting with the local head of the tax audit division (i.e. the appeals officer or *interlocuteur départemental*).
- After considering the written arguments of the taxpayer (and generally only after the meetings described above have taken place), the tax authorities either reaffirm or amend their initial position in a letter. There is no time limit within which the tax authorities must provide their response.
- In their final response, the tax authorities are obliged to offer the taxpayer the opportunity to take their case to the *Commission Départmentale/Nationale*. This body consists of representatives of the taxpayer and the tax authorities and is responsible for reviewing technical, as opposed to legal, tax issues. Both parties are entitled to submit reports to the Commission, which hears both arguments before issuing a decision. The decision, however, is not binding on the FTA.

- The tax authorities are allowed to raise an assessment to collect the tax only once the Commission has reached its final decision, at the latest within three years from the date of the assessment notice (unless an application for mutual agreement procedure has been filed – *see MAP paragraph below*).

Revised assessments and the appeals' procedure
If the taxpayer still wants to appeal against the revised assessment, then it may submit a *réclamation pré-contentieuse* – a claim prior to court action – to the tax authorities. If there is no response from the tax authorities within six months of the claim submittal, then the taxpayer may elect to take the case to court. Otherwise, the taxpayer can wait for the tax authorities to release their decision, after which the taxpayer has two months from that date to take the case to court.

The first court in which the case may be heard is the *Tribunal Administratif* (TA). Arguments are submitted in writing, although either or both parties may be called to the actual court hearing. Like the *Cour Administrative d'Appel* (CAA), the TA may appoint an independent expert to review the facts presented by both parties before giving its judgment.

Either party may appeal the TA's decision; this appeal would be heard by the CAA. The plaintiff has two months from the announcement of the TA's decision in which to make an application to the CAA.

In very limited circumstances, either party may ask the CE to hear the case. The CE is the supreme corporate and income-tax court, and once it has heard the case it will either issue its own final ruling or instruct the CAA to review the initial ruling decision reached by the TA.

Depending on the provisions of the tax treaty that applies, a taxpayer may at any time decide to pursue a competent authority claim instead of litigation. It is also possible to pursue both routes at the same time.

Resources available to the tax authorities
The resources available to the tax authorities to devote to TP investigations are increasing. Major multinational entities are audited by the *Direction des Vérifications Nationales et Internationales* (DVNI or National and International Audit Administration).

The DVNI is responsible for auditing all companies with a turnover in excess of EUR 152.4 million for industrial companies or in excess of EUR 76.2 million for service companies.

With 30 auditing teams divided by sectors, the DVNI's level of industry-specific knowledge is high. General tax auditors may be assisted by tax inspectors, specialising in TP (30ème Brigade). They can also use dedicated teams in charge of computer-assisted audit or audit of tax credits for research and development expenses.

Use and availability of comparable information
Various databases are available that contain the financial accounts of most of the companies, whether or not listed on the stock exchange. These include InfoGreffe, Diane and Amadeus databases.

The FTA has extensive access to Diane and Amadeus. The inspectors specialising in TP commonly use these tools to check taxpayer's benchmarks or produce their own alternative comparable studies. The DVNI is increasingly inclined to accept or even perform pan-European benchmarks.

Risk transactions or industries
Conversion schemes with a TP element are currently scrutinised in audit situations.

The legal cases listed above illustrate that other sectors, such as retail, may also occasionally be investigated. In addition, it is worth noting that the DVNI's TP and financial inspectors recently have been put together on the same team to enhance efficiency in TP audits involving valuation issues.

It should be noted that the finance Bill for 2014 provided that companies had to prove that they receive an arm's-length compensation in case of transfer of functions or risks to a related party, if their operating income during one of the two following years declines by more than 20% compared to the average of the three financial years preceding the transfer. Even though this provision was invalidated by the Constitutional Council, the FTA still have tax grounds to challenge business reorganisations and it is likely that they will continue to focus on reorganisations, especially when the profits of the considered company decrease.

Limitation of double taxation and competent authority proceedings
The FTA does not publish data on competent authority proceedings.

Advance pricing agreements (APAs)
French tax regulations provide for official APA procedures. Between 1999 and 2004, only bilateral APAs were accepted. The rectifying Finance Law of 2004 (Article 20) codifies the legal basis for APAs and extends their scope to unilateral APAs. The APA procedure is now included in the tax procedures code (see Article L. 80 B 7° of the *Livre des procédures fiscales*). Previously, the only domestic authorisation was through a 1999 FTA regulation. In addition, an APA procedure requesting limited documentation and simplified monitoring is now available to small- and medium-sized enterprises.

Bilateral APAs
In a regulation issued on 7 September 1999, the tax administration defines the conditions under which it would be willing to grant a bilateral APA. This may be initiated only with states that have signed a treaty with France containing a section equivalent to section 25.3 of the OECD model treaty. This regulation is a fundamental change from the prior opinion expressed by the central tax administration, where they saw an APA procedure as a breach of the principle of equality. Under this regulation, the application process can be initiated in France or in the other state. The application may cover all transactions or only certain transactions, covering all or part of the companies' operations (product, function, type of transaction, or line of business). Through preliminary meetings with the FTA, the exact scope of the information (tax, financial, legal, industrial, commercial, etc.) to be provided is defined. A formal request may then be addressed to the FTA at least six months before the beginning of the first fiscal year covered by the APA. Within two months of this application, the same application must be submitted to the other tax administration. An indicative list of information to be provided is included in this regulation, but the basic idea behind this list is to establish constant debate and exchange of information with the FTA as part of

the review of the application. Once the review is completed, a draft ruling is issued for final approval by the taxpayer.

The ruling defines the parties, transactions, TP method(s) elected, assumptions used, revision formula, date of application of the ruling and its duration (three to five years), and contents of the annual report to be issued by the taxpayer. The ruling may not have a retroactive effect.

Unilateral APAs
Unilateral APAs, which until the rectifying Finance Bill of 2004 were not authorised in France, may now be accepted by the French administration. However, in a regulation issued on 24 June 2005, the FTA made it clear that it would still favour the conclusion of bilateral APAs. Unilateral APAs could be granted in cases such as:

- If the bilateral tax treaty does not provide for a MAP.
- If, despite the MAP provided in the bilateral tax treaty, the foreign competent authority refuses to conclude an APA.
- For simple issues such as management fees and allocation key issues.

Small- and medium-sized (SME) enterprises: simplified APA procedure
As the standard APA procedure can be burdensome, a simplified APA procedure for SMEs is available as from 28 November 2006. The simplified procedure proposed by the FTA includes the following:

- Less TP documentation is required for the APA request. The documentation is limited to a legal chart of the group, the list of transactions and prices between related parties, functional analysis, description and justification of the TP method, and the financial statements of the foreign companies involved in the transactions.
- The FTA assists in the preparation of the functional analysis and in the choice of the appropriate TP method.
- An economic analysis is also requested. During an experimental period, the FTA may perform the benchmarking analysis at the request of the SME.
- Simplified content of the annual compliance report requested in the follow-up years of the APA (e.g. details of the computation of the remuneration and a statement on the substantial changes to the activity conditions described in the APA request, such as activities, functions performed, risks borne, legal/de facto dependence, assets used, accounting methods).

Only SMEs that meet the following two criteria are eligible for the simplified APA procedure:

- SMEs with i) fewer than 250 employees, and ii) a net turnover of less than EUR 50 million or with assets that do not exceed EUR 43 million.
- 25% or more of the capital or voting rights are not owned by one enterprise, or jointly by several enterprises that do not meet the conditions of the previous paragraph.

To determine whether the criteria are met, reference should be made to the financial year preceding that in which the request to initiate the procedure is submitted.

Mutual agreement procedure (MAP)
The Finance Law of 2014 repealed the suspension of the collection of taxes when a competent authority procedure is undertaken by the taxpayer to eliminate double taxation following a notice of reassessment (formerly under Article L. 189 A of the Tax procedures code). After issuing a notice of reassessment the FTA has three years to issue a collection notice, notwithstanding the taxpayer's undertaking of a competent authority procedure. The FTA may accordingly ask for payment to the taxpayer before the competent authority procedure is concluded. After receipt of the collection notice, the taxpayer can request to benefit from deferral of payment of taxes based on domestic law. However, under the deferral of payment procedure, the taxpayer incurs interest for late payment as from the date of the collection notice if it loses the case.

In February 2006, the French revenue issued a first regulation regarding MAP.

This detailed regulation provides guidance pertaining to the scope, conditions and implementation of the MAP in France. It also aims to apply the recommendations encapsulated in the code of conduct elaborated by the EU Joint Transfer Pricing Forum with respect to the implementation on the EU Arbitration Convention.

Binding permanent establishment (PE) ruling
The amended Finance Bill for 2004 (Article 19) extends the tax ruling procedure to PEs (Article L. 80 B 6° of the Tax Procedures Code, Livre des procédures fiscales). Under the extended procedure, foreign companies may request a ruling from the FTA stating whether their business activity in France constitutes a PE or a 'fixed place of business', according to the bilateral tax treaty between France and the parent company's country of residence. Not only may the ruling apply to subsidiaries, but also it can relate to agents, regardless of whether they are independent (see Article 5 §6 OECD Model Convention), or branches, regardless of whether their only purpose is to hold and deliver the parent company's goods (see Article 5 §4 OECD Model Convention). When a request for a ruling is sent, the FTA has three months to reply. If the FTA does not reply within that time period, the request is automatically approved. The French subsidiary of the foreign company is, therefore, not deemed a PE in France, and the group is not liable for corporate income tax in France, consequently avoiding double taxation.

The approval binds the FTA, which may not issue tax reassessments for periods prior to the ruling. This new procedure is, however, limited exclusively to taxpayers acting in good faith (*contribuables de bonne foi*), i.e. taxpayers having provided all the useful elements to decide whether a business constitutes a PE and has not provided wrong or incomplete information. The tax authorities may change their decision regarding periods after the ruling, as long as the taxpayer is informed of that change. This procedure is applicable as from 1 January 2005 (*see Decree of 8 September 2005*).

Liaison with customs authorities
The tax authorities have the authority to use information gathered by the customs' authorities when challenging a TP policy.

Joint investigations
There is little information about joint investigations, although it is generally thought that the tax authorities participate more in these now than in the past. In particular, the French authorities tend to join forces with their counterparts in the United States, Germany, Belgium and the United Kingdom.

Section L 188 A – Statute of limitation

Section L 188 A provides for an extension of the statute of limitations and is open to the authorities when they request information from foreign tax administrations before the end of the initial statute of limitation. The new statute of limitation expires at the end of the year following the year when the information requested is obtained and at the latest at the end of the third year following the expiration of the initial statute of limitation. For example, if the financial year corresponds to the calendar year, intragroup transactions conducted in 2012 may, in principle, be investigated within the framework of the authorities investigating a company, up to 31 December 2015. If a request for information is sent to a foreign tax authority in December 2014, these 2012 transactions may remain open to reassessment for the years 2016, 2017 and 2018.

The extension of the statute of limitation applies if there is a request for information bearing on intragroup transactions or on entities established in countries with favourable tax regimes (FTC section 209 B), but also in cases of requests for information with relevance to the foreign assets, credits, income or activities of a French taxpayer.

Comparison with OECD Guidelines

The French tax authorities have not published a formal interpretation of TP guidelines issued by the OECD. Indeed, there has not yet been any commentary on the Guidelines issued in July 2010. At various times, however, such as at public seminars, the tax authorities have indicated that they do refer to the OECD principles during audits and settlement procedures.

An explicit reference to the OECD principles was made for the first time in the regulation of 23 July 1998. Reference to these principles is also made in the APA and TP documentation regulations referred to above.

The courts tend to use the OECD's principles as guidelines (Fisons, TA Lyon, 25 April 1990).

France

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Georgia

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Overview

Georgia is making its first steps in preparation and implementation of transfer pricing (TP) regulations and guidelines. Some provisions relevant to TP for international transactions were introduced with the new Tax Code from 2011; they provided general principles and were not widely applied in practice. In general they established the criteria for assessment of transactions between related parties as being comparable with transactions between non-related parties. However, there was no detailed guidance until the end of the year 2013. The instruction on assessment of international controlled transactions released by the Georgian Ministry of Finance of Georgia on 18 December 2013 has provided the first detailed methodology for the application of TP principles. The instruction is based on the key principles outlined in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.
As a result of the new regulations, Georgian taxpayers are obliged to prepare TP documentation for their international controlled transactions from year 2013.

Country	Georgia
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	TP documentation should be prepared for all controlled transactions; however, it should be provided to the tax authorities only upon their request within 30 days
Must TP documentation be prepared in the official/local language?	No

Georgia

Country	Georgia
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	N/A

Introduction

Certain TP concepts have been included in the Georgian tax legislation since 1993 (Law of Georgia on Corporate Income Tax). Although specific provisions related to TP had been very limited, some general TP rules were added to the Georgian Tax Code on 13 June 1997.

Similar provisions were incorporated into the latest tax code, effective from 1 January 2011. In particular, Articles 126 – 129 provide the basis for TP control by the tax authorities.

Specific TP regulations became effective from 1 January 2011. Even though the Tax Code enlists applicable pricing methods, the law is not detailed, and the Government's position on issues such as compensating adjustments, documentation, information sources on arm's-length prices and burden of proof was not available until the end of 2013. On 18 December 2013, the instruction on assessment of international controlled operations was approved by the Georgian Ministry of Finance. It provides the implementation guide for TP rules and is based on the international TP principles developed by the OECD.

The Tax Code stipulates that, in accordance with the Ministry of Finance instruction, the tax authority may recalculate the taxes if they can prove that the prices applied by related parties of transactions differ from market prices.

Legislation and guidance

Scope

The Georgian tax authorities may evaluate TP involving the following types of transactions:

- International transactions conducted between the related parties.
- International transactions conducted with the residents of blacklisted/ offshore countries.

Related parties

Parties are recognised as related if their relationship could affect the conditions or economic results of their activities. For example:

- One person directly or indirectly holds or controls the majority of the voting rights.
- One person can control the composition of the board of directors.
- One person has a right to share in 50% or more of the profit of the enterprise.
- A person's relative directly or indirectly holds 50% or more of the enterprise, or directly or indirectly runs the enterprise.
- The sum of loans provided by a person to the enterprise and loans of the enterprise guaranteed by it is greater than 50% of the enterprise's total assets.

Pricing methods
The following TP methods can be used for evaluating whether the prices are arm's length:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Net profit margin method.
- Profit split method.

The most appropriate TP method should be selected when assessing whether the transaction price is consistent with the arm's-length principle, considering the respective strengths and weaknesses of the method, its appropriateness and the availability of reliable information.

Internal uncontrolled transactions as well as external can be used for the comparability analyses.

Risk transactions or industries
Transactions that might be subject to transfer pricing risk include: inter-company loans, service transactions, transactions involving intangible assets and export/import.

Management services
Although the Georgian Tax Code does not specify TP regulations with regard to management services, such transactions may be scrutinised for elements of TP, given that they are provided or received in one or more of the following ways:

- By related parties.
- On a free-of-charge basis.
- As part of a barter transaction.

The more significant issue with management services is that such services generally have a source in Georgia under the Tax Code, and therefore would be subject to 10% withholding tax unless exemption is available under a relevant tax treaty.

Thin capitalisation
Thin capitalisation rules are planned to become effective from 1 January 2016. Interest expense is disallowed on any debt in excess of three times the equity of a company. The law does not indicate how debt and equity are measured.

The rules do not apply to:

- financial institutions
- entities that have gross income of less than 200,000 Georgian lari (GEL), and
- entities with interest expense that is less than 20% of their taxable income before deducting that interest expense.

The maximum rate for which interest may be deducted is 24%, as defined by the Georgian Minister of Finance.

Other regulations
Not applicable.

Anticipated developments in law and practice
Rules and instructions for the procedures of bilateral and multilateral advance pricing agreements (APAs), mutual agreement procedures and corresponding adjustment are expected to be issued.

Liaison with customs' authorities
The tax and customs' authorities have been merged into one body that is overseen by the Ministry of State Revenues. A new, unified database was introduced that makes import and export information easily available to the tax authorities.

Penalties
There are no specific penalty regulations for the violation of TP rules. However, TP adjustments made by the tax authorities during a tax audit that would increase the taxable revenue of the taxpayer may be subject to tax underpayment administrative measures.

Specific measures include, but are not limited to, the following:

- Underreporting of tax liability in the tax return – 50% of the underreported amount.
- Return late submission – 5% of the tax liability per each overdue month. Maximum penalty should not exceed 30%.
- Late payment interest – 0.06% of the due tax amount per late day of payment.

Documentation
Georgian TP legislation requires companies to prepare TP documentation for all related-party transactions and supply it to the Georgian tax authorities upon their request within 30 days.

The TP documentation should include:

- Overview of the company's commercial activities.
- Structural description of the company.
- Information about the controlled transaction.
- Description of selection of the most appropriate TP method.
- Comparability analyses.
- Description of any comparability adjustment performed.
- Economic analyses and forecasts.
- Any other information, which may have an essential influence on establishing comparability of the controlled transaction with the arm's-length principle.

Transfer pricing controversy and dispute resolution

Tax audit procedures
Georgian tax authorities are allowed to conduct tax audit procedures only once a year, unless there is reliable information for a more frequent audit because of tax evasion. No specific regulations related to TP tax audits are provided in the Tax Code.

Burden of proof
The burden of proof can lie with the taxpayer or the tax authority, depending on which party claims a TP adjustment is required.

Revised assessments and the appeals' procedure
Currently, the appeals' procedures for any tax-related matters involving significant amounts are slow and may result in a change in the initial assessment, based on available evidence. At this time, the court system is not a viable alternative.

Resources available to the tax authorities
In recent periods the tax authorities have started paying more attention to TP issues during tax audits. There is no specialised TP team within the Revenue Service. As such, for the arm's-length price analysis the tax authorities may rely on different sources of information, e.g. internal or external comparables, if such information is available for the taxpayer. Otherwise, other sources may also be used. Under certain circumstances, the tax authorities have relied on information from other outside sources. In one such case, the Council of Tax Appeals obtained needed information directly from the foreign customs' authorities.

The Georgian Revenue Service recognises information from various TP databases like AMADEUS produced by Bureau van Dijk, etc.

Use and availability of comparable information
Based on experience, the most common procedure used by the tax authorities is to rely on information collected themselves from other similar taxpayers and/or information published by the State Statistics Committee. The Revenue Service started negotiating with private companies to obtain access to commercial TP databases. In isolated cases, tax authorities are successful in obtaining information from their foreign counterparts.

Currently, the Georgian tax authorities try to obtain extensive information from other similar markets worldwide.

Limitation of double taxation and competent authority proceedings
Upon request, the tax authorities may make a corresponding adjustment to mitigate or eliminate double taxation in cases where another tax administration has taxed that portion of profit that had already been taxed in Georgia.

Joint investigations
No such procedures are known to be taking place.

Advance pricing agreements
Any taxpayer may apply for an APA. It is binding on the tax authorities, but only with regard to the taxpayer who is part of the agreement for the covered transaction within the covered period.

Comparison with OECD Guidelines
The Georgian TP law follows the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

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Overview

The most recent notable transfer pricing (TP) development in German legislation involved the implementation of the authorised Organisation for Economic Co-operation and Development (OECD) approach (AOA) into national tax law. In light of the 2010 OECD Report on the Attribution of profits to Permanent Establishments (PEs), the German tax authorities have implemented the AOA with effect from 1 January 2013. Following a typical three-layer structuring process in Germany, an Ordinance on income allocations of PEs was published on 13 October 2014. This Ordinance has legal status. In addition, Administrative Principles on the income allocation of PEs as a guideline to the German tax authorities are expected to be released later in 2015.

Until 2012, Germany mainly applied the Relevant Business Activity Approach for the income allocation between the head office of an enterprise and its PE. Therefore, the implementation of the AOA constitutes a considerable change of the former practice of PE income allocation in Germany. As a result, foreign taxpayers with domestic PEs or domestic taxpayers with foreign PEs are forced to revisit implemented PE income allocation processes and approaches regarding compliance with the new requirements.

The Ordinance mainly follows the AOA; however, there are many specific features that deviate from the general principles of the AOA. In particular, the regulations include German specifics regarding (i) the preparation of the so-called auxiliary and supporting calculation, (ii) the definition of the people function, and (iii) the free capital to be allocated to the PE. By analogy to the functional and risk analysis and the TP analysis applicable to related enterprises, a two-step analysis is stipulated for purposes of the income allocation between head office and its PE.

Country	Germany
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes, in principle.
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Generally, no.
Does TP legislation adhere to the arm's-length principle?	Yes

Germany

Country	Germany
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Generally, upon request by tax authorities (then within 60/30 days). Contemporaneous documentation for extraordinary transactions.
Must TP documentation be prepared in the official/local language?	In German, unless exemption is granted.
Are related-party transactions required to be disclosed on the tax return?	Generally, no.
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Percentage of income adjustment or daily amount for late presentation. Additional remedies possible.

Introduction

German legislation stipulates in section 1 of the Foreign Tax Act the arm's-length principle as the norm for related-party transactions. Accordingly, the prices for those transactions have to be settled on these grounds, applying, if possible, the traditional TP methods. The appropriateness of transfer prices has to be laid out in a documentation, which is regularly requested as part of tax audits. The approach of the tax authorities to TP issues, in particular to acceptable pricing methodologies and competent authority proceedings, is undergoing continual change in response to international developments in these areas.

Germany has been focusing on TP for many years now. While generally adhering to OECD principles, local regulations in certain areas, such as the specific rules on transfer of functions (i.e. business restructurings), or on the applicability of TP methods, tend to deviate somewhat from international standards and respectively contain particular variances to OECD principles. The level of sophistication of the tax authority with respect to TP is generally advanced, and the authorities have TP auditors specialising in specific industries and technical areas. Germany has a wide network of modern double taxation treaties, and does accept applications for bilateral and multilateral advance pricing agreements (APAs).

Legislation and guidance

The statutory rules on TP are not found within one integrated section of the legislation, but in several provisions in different statutes. However, in the meantime, the legislative body has developed the Foreign Tax Act, or *Außensteuergesetz* (AStG) as the main source for TP guidance. Section 1 of the AStG contains rules on:

- The definition of the arm’s-length principle including the notion that unrelated parties would have knowledge on all relevant facts and circumstances of the transaction and would act as prudent and diligent business managers. This definition is supplemented by the hypothetical arm’s-length principle, which shall be applied if the set of comparables does not meet limited comparability requirements.
- The definition of related parties, which means an ownership of 25% or more.
- The establishment of the preference of traditional transaction-based methods, and the limitation of profit-based methods to cases where the three traditional methods are not appropriate.
- The emphasis on the adjustment of TP ranges; if no fully comparable data exists, TP ranges need to be narrowed. When a taxpayer selects a transfer price outside of the range, the adjustment will be made to the median of the range.
- The introduction of the Transfer of Function rules, which leads to the establishment of an exit taxation, if certain functions, risks, assets and opportunities are relocated.
- The general authority to adjust transfer prices that do not meet the arm’s-length requirement including a price adjustment mechanism that allows for adjustments within a ten-year period.

Other important provisions include section 90, Paragraph 3 of the General Fiscal Code or *Abgabenordnung* (AO) as well as section 162, Paragraph 3 of the AO on documentation and penalties (*refer to the respective sections below*).

The 2008 legislation revised section 8a of the AStG regarding thin capitalisation rules. These rules have been replaced by a general limitation on interest deductions. The thin-capital rules that restricted the deduction of interest on shareholder loans have been replaced by an interest deduction limitation rule. Under the new rules, the allowable net interest expense is restricted to 30% of taxable income before interest, taxes on income, depreciation and amortisation. There is no limitation on the deductibility of interest in the following circumstances:

- Where the net interest expense is less than 1 million euros (EUR).
- Where the company is not part of a group and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.
- Where the company is a member of a group, but its borrowings do not exceed the borrowing ratio (as shown by the financial statements under a common accounting convention such as International Financial Reporting Standards [IFRS] or US generally accepted accounting principles [GAAP]) by more than 1% and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.

Similar principles apply to corporate holdings in partnerships and there are related party and right-of-recourse rules for shareholders to catch back-to-back financing and other perceived abuses. Any net interest expense that has been disallowed on a given year because it exceeds the 30% threshold may be carried forward for relief in future years. The net interest expense is then treated as a net interest expense of the year concerned, with the same conditions applying.

In addition to the adoption of formal statutes by Parliament, the authorities are authorised to issue so-called Ordinances (*Rechtsverordnungen*) on specific matters, which need to be approved by the upper house and have statutory character in that they are binding for taxpayers and tax courts. With respect to TP documentation (TPD), an Ordinance was published in 2003, providing guidance and binding interpretation on the type, contents and scope of the documentation required (*Gewinnabgrenzungsaufzeichnungsverordnung* – GAufzV). With respect to section 1, Paragraph 3 of the Foreign Tax Act, the authorities issued an Ordinance specifying further details regarding the TP rules on cross-border transfer of functions (*Funktionsverlagerungsverordnung* – FVerlV). The Ordinance covers details on (i) the terminology of section 1, Paragraph 3 of the Foreign Tax Act, (ii) the valuation to be used with respect to the so-called transfer package, and (iii) retroactive price adjustments. Recently, the Ordinance on income allocation of PEs was introduced.

Administration principles issued by the tax authorities

The tax authorities do not have the authority to issue legally binding regulations on TP matters. They are, however, authorised to promulgate general regulations, decrees on special topics, proclamations, etc. on any issue as considered appropriate including TP matters. All such promulgations are binding only on the tax authorities, and this tool is used extensively by the authorities to promote their interpretation of statutory law and court decisions. Accordingly, these promulgations indicate the position of the tax authorities and therefore have considerable relevance in tax practice. From a TP perspective, the regulations set out below are of particular interest.

On 23 February 1983, the Federal Minster of Finance published the Principles relating to the Examination of Income Allocation in the Case of Internationally Affiliated Enterprises (administration principles). These principles contain the general rules on the international income allocation where related parties are involved as well as an extensive discussion on the rules of law governing income allocation. Also included are positions on various types of inter-company transactions. The original version of the administration principles also contained guidelines on cost-sharing arrangements, methods of adjustment and related procedural aspects, but these sections have been replaced by new regulations (*see below*).

The administration principles generally follow the 1979 OECD Guidelines. They have been under revision for some time to incorporate developments since 1979 and, in particular, to catch up with the current OECD standards. The 1983 administration principles were changed or amended by the following additional principles:

The revised principles on cost-sharing arrangements published in 1999, the new chapter on international secondments published in 2001 and the revised principles on procedural aspects published in 2005, incorporate the tax authorities' interpretation of questions regarding the documentation of the facts and circumstances that relate to relevant TP arrangements. Importantly, these principles refer to the requirements to document the appropriateness of transfer prices. Taxpayers' documentation of the appropriateness of transfer prices must be exclusively oriented towards the arm's-length principle and is the core of the administration principles on procedures.

On 13 October 2010, the German Federal Ministry of Finance issued the administration principles relating to the Examination of Income Allocation between Related Parties in case of Cross-Border Transfer of Functions (administration principles on transfer

of functions). These principles explain the view of the German tax authorities with respect to terms and definitions as well as examples on how the arm's-length price 'exit charge' for a transfer of function should be calculated. According to the administration principles on transfer of functions, the determination of an exit charge should follow a capitalised earnings or discounted cash-flow evaluation, all based on generally accepted evaluation methods. Furthermore, the evaluation has to be performed for each of the two parties involved in the transaction, based on an indefinite capitalisation period, using discount rates calculated as specified in the principles and setting the transfer price at the median of both evaluation results. If the taxpayer's approach deviates from this general approach, the burden of proof is shifted to the taxpayer. The principles also describe the three main 'escape clauses'. However, it may be difficult to actually apply them in practice as the requirements are set at a high level and the burden of proof for the fulfilment of these requirements is with the taxpayer.

In addition, documentation requirements are detailed and non-compliance with these requirements does allow the tax authorities to deviate from the transfer price applied, which may result in significant additional taxes. The administrative principles include some helpful clarifications, e.g. on the shift of a single customer order, centralised order allocation to group entities, replacement of 'old' by 'new' products (and shift of manufacturing tasks for 'old' products to an affiliate), or consequences where the other party terminates an agreement by giving notice. Even if the administration principles are effective from fiscal year 2008 onwards, they state that that part of the regulations is for clarification only and, therefore, will be applied by the German tax authorities to all open cases, irrespective of the fiscal year they relate to.

Court cases

Transfer pricing issues historically were settled by compromise or negotiation, long before they reached the courts; hence, there have been very few court cases on the subject. There are two levels of courts, and all cases that are heard by the courts may last several years before a final decision is reached by the Federal Tax Court or *Bundesfinanzhof* (BFH) (i.e. the higher court). Decisions by the BFH establish a binding precedent on the lower tax courts on a particular subject. However, the German tax authorities do not always accept BFH decisions as binding for all similar cases and so may publish instructions that a certain court case is not to be applied by the tax authorities on other cases.

Most published court cases on TP issues deal with the interpretation of the arm's-length principle and the tax consequences resulting from a violation of this principle. In substance, the courts typically verify whether transactions between affiliated parties are based on upfront (written) agreements and result in an income allocation comparable to that arising from transactions between third parties. The test question commonly asked by the court to establish this is whether a prudent and diligent manager (*ordentlicher und gewissenhafter Geschäftsleiter*), in exercising the required professional diligence, would have applied similar conditions on third-party transactions.

One of the most important TP cases decided by the BFH in the past decades is the judgment on 17 February 1993 (I R 3/92), which was published in the Federal Tax Gazette 1993 II p. 457. This case established an important principle that was summarised by the court itself as follows:

> '… an orderly and diligent manager will, for the corporation managed by him, introduce to the market and distribute a new product only if he can expect, based on a prudent and pre-prepared economic forecast, a reasonable overall profit within a foreseeable period of time with due consideration to the predictable market development'.

The decision covers a variety of aspects including the treatment of marketing expenses and the permissible scope of start-up losses. In many respects, the decision is significant for German distribution affiliates of international groups, which are in a continual overall loss position. Such a loss-making affiliate should anticipate encountering difficulties in convincing tax auditors that losses incurred over several years would have been accepted in dealing with true third parties.

This decision covered the market introduction of a new product by an already established company and stated that typically, a market introduction phase, where losses are acceptable, should not be longer than three years. In contrast to this, a BFH decision dated 15 May 2002 stated that a start-up loss phase resulting from market influences of a newly founded company can be substantially longer on a case-by-case basis. The typical start-up phase of three years is, consequently, regularly extended in case of newly founded companies.

An even higher impact on German TP practices and procedures results from the BFH decision of 17 October 2001 (I R 103/00, published in the Federal Tax Gazette 2004 II p. 171). Not only does this judgment refine principles established in the case on 17 February 1993, but also it provides substantial guidance on procedural issues, such as the judicial revision of data introduced by the tax authorities, of (secret) comparables, the burden of proof, the consequences of lacking cooperation by the taxpayer, the scope of TPD requirements, as well as the determination of arm's-length transfer prices within acceptable ranges. Further references to this judgment will be made in the following sections. It needs to be understood that the German legislature reacted to this decision, in particular, by introducing statutory TPD requirements in section 90, Paragraph 3 of the AO and promulgating penalties in cases of non-compliance with these obligations in section 162, Paragraphs 3 and 4 of the AO. To this extent, the principles of the BFH decision dated 17 October 2001 are no longer unrestrictedly applicable to the years 2003 onwards. However, it should be emphasised that even after the introduction of statutory documentation requirements, the burden of proof for transfer prices not being at arm's length is still with the tax authorities, and that the other findings of the BFH in its 17 October 2001 decision remain in force.

Within its decisions of 27 August 2008 – reconfirmed by the decision of the BFH dated 29 April 2009 – the BFH interpreted the term 'business relationship' under section 1 of the Foreign Tax Act. A business relationship between related parties shall not exist if a parent company does not sufficiently capitalise its subsidiary, but provides the subsidiary with free 'capital replacements', which a third party would not have provided (such as an interest-free loan or a binding letter of comfort). If the subsidiary is not able to perform its business operations without the capital replacements, the provision of such capital replacement is not qualified as a business relationship between related parties and, hence, is not subject to income adjustments according to section 1 of the Foreign Tax Act.

One of the regional tax courts – the tax court of Cologne – rendered an important decision on 22 August 2007 on the need of upfront (written) agreements for inter-company transactions. The court states that German national law clearly requires having such agreements in place in order to avoid income adjustments. However, the court also clearly acknowledges that Germany will not be able to uphold such a formalistic position under a double-tax treaty (DTT) where the emphasis is put on whether – irrespective of the fulfilment of formalities such as written agreements – transfer prices are arm's length. The decision is mostly meant to underline the fact that the German tax authorities generally will not be able to attack transfer prices solely for the lack of inter-company agreements. It is interesting to note that the tax authorities have not appealed the court decision and seem, consequently, to acknowledge its findings.

Nevertheless, in practice it remains advisable to enter into upfront agreements with respect to inter-company transactions. Another regional tax court – of Münster – rendered an important decision on 16 March 2006 on the allocation of location savings. According to the court the savings should be shared between the location of a contract manufacturer that operates in an environment with a lower wage level and the entrepreneur.

In a case recently decided by the tax court in Münster, a Polish subsidiary gratuitously used a trademark registered in the name of its parent German company. As a result of a tax audit, the tax base of the German parent company was adjusted under section 1 of the Foreign Tax Act. The German parent company entered into litigation in order to refuse the tax base adjustment. On 14 February 2014, the lower tax court of Muenster ruled on the case and commented on the intragroup use of trademarks. The case was permitted to be taken to the Federal tax court and is currently pending there. In the case at hand, a German parent company and trademark owner registered a trademark in six European countries ten years before its Polish subsidiary was founded. Accordingly, the tax court assumed that the trademark and its perception have been established in Europe before entering the Polish market. The trademark and its perception have been expanded to Poland shortly before the Polish subsidiary was founded and commenced its business activities. Subsequently, the Polish subsidiary, a distribution company, used the trademark for marketing purposes in various manners. In the court's view, the Polish company used the trademark gratuitously, though it did not contribute to its value creation. As a result, the court decided that the tax base of the German parent was rightfully adjusted, based on section 1 of the Foreign Tax Act, to meet the arm's-length criteria. Regarding the assumption that the Polish company did not contribute to the creation of the trademark on the Polish market, the court apparently referred to the protective rights related to the trademark, based on its trademark registration rather than on the question: Had local marketing efforts been undertaken?

Penalties

Section 90, Paragraph 3 of the AO contains the documentation requirements for cross-border transactions with related parties including PEs. Non-compliance with these requirements can lead to a number of consequences including the following:

- Section 162, Paragraph 3 of the AO – Consequences of inadequate or missing documentation (assumption of need for profit adjustment, income estimation by use of least favourable point in a price range).

- Section 162, Paragraph 4 of the AO – Penalty of 5% to 10% of profit adjustment (with certain ceilings/restrictions) in case of non-compliance with documentation requirements.
- Section 146, Paragraph 2b of the AO – Penalty of EUR 2,500, up to EUR 250,000 in case of failure to cooperate with the tax authorities.

Any unfavourable TP adjustment will also result in an increase of taxable income, which in most cases leads to the treatment as a hidden dividend distribution. This is taxed with the corporation tax rate of 15% (through 2007, 25%) as well as the trade tax (unless balanced by tax loss carry-forwards). To the extent a TP adjustment will be treated as a hidden dividend distribution, additional withholding taxes (WHTs) may become due; even if DTTs or supranational law (e.g. the EU Parent-Subsidiary-Directive) provide for reduced WHT rates, such reduction may be achieved only by a formal application. Additional penalties for TP adjustments, other than interest charges, which are levied on every delayed tax payment, are generally unknown under the present laws as part of the taxation process and could be an issue in criminal proceedings only.

Documentation

The German rules request documentation on details of cross-border transactions with related parties including the economic and legal basis for an arm's-length determination of prices and other business conditions. The GAufzV provides guidance and binding interpretation on the type, contents and scope of the documentation required, and contains a detailed catalogue on the specific items that should be provided within the TPD, such as:

- general information on shareholder relationships, operations and operational structures
- transactions with related parties including: (i) an overview over the types and volumes of inter-company transactions, the underlying contracts and any changes thereto, as well as (ii) a list of essential intangible property owned or used by the German taxpayer
- analysis of functions and risks including a description of the value chain and the taxpayers' contribution to the value chain relative to other group companies, and
- TP analysis including the description of TP method(s) used, justification of the method(s), calculations using the method(s) as well as comparable data and adjustments.

Documentation must be prepared within a reasonably short period (i.e. within six months after the end of the business year) for extraordinary transactions, such as corporate restructurings as well as material long-term contractual relationships. Documentation for all types of transactions must be presented to the authorities upon their request, typically in the course of a tax audit. The time limit for presentation is 60 days following the request (respectively, 30 days in case of extraordinary transactions); extensions may be granted for special reasons.

In determining an arm's-length price, section 1, Paragraph 3 of the Foreign Tax Act advises to primarily use the traditional transactional pricing methods: comparable uncontrolled price (CUP) method; resale price method (RPM); and cost plus (CP) method. Profit-related TP methods are also generally accepted in tax audit practice and their use is supported by the administration principles. The administration principles

on procedures explicitly acknowledge that, under certain conditions, the use of other methods may be appropriate. Specifically, the use of the profit split method (PSM) or the transactional net margin method (TNMM) is mentioned for specific cases; the latter can generally be applied if (i) no standard method is applicable, (ii) an enterprise carries out only routine functions, and (iii) at least a limited comparability exists based on comparable data.

The administration principles also allow companies to apply profit-based TP methods to the extent that useful comparable data cannot be determined on the basis of the traditional methods. However, the application of the comparable profit method (CPM) is explicitly rejected (i.e. TP methodology must be strictly transactional).

The application of the TP methods depends inter alia on the structure of the company under review. The German tax authorities differentiate between three categories of companies:

- Companies with routine functions and no considerable contribution to the value chain – allowed methods: standard methods and TNMM; companies with an entrepreneurial-type structure (so-called strategy leaders) – allowed methods: standard methods with respect to its affiliates; PSM between companies of the same structure.
- Companies exercising more than routine functions, without having the profile of an entrepreneur – allowed methods: standard methods, determination of transfer prices based on internal planning data with arm's-length profit forecasts.
- Companies having an entrepreneurial profile – allowed methods: any method that leaves in principle the residual profit with the entrepreneur.

Hence, Germany follows the international trend of using profit-based TP methods for the determination of arm's-length transfer prices; however, certain restrictive conditions must be fulfilled. This happened inter alia against the background that it is becoming more and more difficult in competent authority or arbitration proceedings to reject profit-related pricing methods where other countries are applying such methods.

Transfer pricing controversy and dispute resolution

Tax audit procedures

The German tax authorities do not normally perform tax audits specifically for TP issues; rather they examine TP during the normal tax field audits, which are performed at regular intervals. With the exception of small business entities, German enterprises are generally subject to regular tax field audits, which usually cover three to five consecutive years. Almost all tax audits are focusing on TP, and tighter investigations by tax auditors into TP issues are occurring in light of extensive new rules and a nationwide TP programme for tax auditors.

Since the introduction of legal documentation requirements, companies should be prepared to provide the documentation of their cross-border transfer prices within the limits of section 2, Paragraph 6 of the GAufzV, already on receipt of the official advance notice (*Prüfungsanordnung*) of the tax audit. The time limit of 60 days (respectively, 30 days for so-called extraordinary transactions) for submitting this documentation starts in these cases with this official advance notice. However, an unspecified flat request for documentation is not allowed; companies should consider objecting if confronted with such an unspecified flat request.

Duty of taxpayer to cooperate with the tax authorities

The tax authorities may request any information considered relevant to all transactions throughout the audit period, and the taxpayer is obliged to cooperate with the authorities. Where the investigation concerns cross-border transactions, German taxpayers are under an increased obligation to cooperate. Information on foreign affiliated parties must be provided, if requested, as far as the taxpayer has factual and legal access to the requested data. Where the requested data is not provided, even though the German taxpayer would have had the possibility to obtain such information, the tax authorities are entitled to estimate 'appropriate' transfer prices, based on simplified methods, which may result in an adjustment of taxable income.

The 2008 legislation introduced the notion that, if foreign-related parties will not disclose information that is relevant for the transfer prices of a German entity, the transfer prices of the German entity can be estimated at the end of the range that is most unfavourable for the German taxpayer.

Field audits in practice

Field audits, in most cases, are carried out at the premises of the taxpayer. The tax auditor notifies the taxpayer of the intended visit and the scope of the audit, typically some weeks before the audit commences. Depending on the size, complexity and availability of information, an audit may take between a few days and many months, or even years. Effective in 2002, special procedures have been established to allow spontaneous VAT audits with no warning to the taxpayer. Depending on the results, such a special audit may be continued as a regular tax audit covering other taxes including TP.

As of 2002, the tax authorities are entitled to access the electronic records of taxpayers, who are required to make their data available. At their election, the authorities may take direct access or may request that the taxpayer process and evaluate data at their specification. Finally, the authorities may also require copies of all data in a form suitable for further processing.

As a result of the field audit, the tax auditor summarises the findings and any tax adjustment considered necessary in a written report. It is common tax audit practice that the tax auditor, before finalising the report, continues to correspond with the taxpayer, or their advisers to try to settle all the issues of concern. Regularly, a final meeting is held between all parties involved to evaluate the material findings. It should be noted that negotiation is an important element of most tax audits and that in most cases a final settlement is reached by compromise.

In case of internationally affiliated companies, the examination of cross-border transfer prices is increasingly the focus of tax audits. Hence, the tax risks resulting from transfer prices not being at arm's length should not be underestimated, in particular against the background of respective sanctions that may apply in such cases. In this respect, the quality of the documentation of the appropriateness of transfer prices is of particular importance, as it may result in minimising the risk of income corrections. Simply said, the better the documentation of transfer prices with regard to their arm's-length character, the lower the risk of income corrections. In addition, solid TPD may help to shorten the duration of a tax audit.

Resources available to the tax authorities
Central authority for all international tax matters including TP lies with the Federal Tax Office (*Bundeszentralamt für Steuern*). The Federal Tax Office collects all information and data of relevance for international taxation and TP issues. This central extensive statistical information is confidential and is available to the tax administration only.

In local tax audits, matters of international importance may be presented by the local tax auditor to the Federal Tax Office for review, and expert auditors of the Federal Tax Office with specialisation in TP or other international tax matters may assume responsibility for respective segments of local tax audits. The Federal Tax Office relies entirely on internal expertise rather than on outside consultants, or other experts.

In recent years, the German Revenue has identified TP as a strategic area of the highest importance, and considerable efforts are being made to strengthen this area, both from a personnel experience and an organisational point of view. Internationally affiliated taxpayers are being increasingly investigated by tax auditors with special cross-border experience, and that experience includes TP. The responsibility for larger companies (which typically have international group affiliations) also lies with special regional tax offices, which have an increasingly TP expertise.

Liaison with customs' authorities
In the past, income tax and customs' authorities normally worked independent of each other, with little or no communication or exchange of information. However, this is gradually changing and it can no longer be excluded that TP adjustments may result in a reassessment of customs' duties, or vice versa.

Joint investigations
The tax treaty provisions and additional European Union (EU) provisions on the exchange of information, competent authority, arbitration and consultation proceedings provide a procedural framework for the German tax authorities to join another country in a joint investigation of a multinational group for TP purposes. The German tax authorities have implemented a task force within the Federal Tax Office to promote joint investigations. Some audits have been conducted under this regime already. Nevertheless, practical problems (e.g. lack of personnel and language problems) remain.

Revised assessments and the appeals' procedure
The tax auditor is not authorised to issue revised assessments for the years under audit. The final report including suggestions for any tax adjustment is presented to the local tax office where the revised tax assessments are prepared, usually in accordance with the recommendations of the tax auditor. The taxpayer may appeal against the revised assessments. If the appeal is denied by the appeal's department of the respective tax office, the taxpayer may appeal at court. Such appeals would be heard first by the regional tax court and then, if admitted, by the Federal Tax Court.

Limitation of double taxation and competent authority proceedings
Competent authority provisions are an integral part of the extensive German treaty network, and proceedings normally follow the pattern of Article 25 of the OECD Model Tax Convention. Retroactive adjustments arising from TP issues, which may result in a reduction of German taxes, may be allowed even where tax assessments have become final and would not, in accordance with domestic tax law, otherwise be allowed.

Depending on the complexity and/or importance of the subject matter, a competent authority proceeding may take between a number of months to several years.

The administration principles on procedures explicitly mention that in case of an imminent double taxation caused by TP corrections of a foreign or national tax authority, the opening of a mutual agreement procedure (MAP) or EU arbitration procedure may help to remove this double taxation by means of corresponding counter-income corrections. For this purpose, in case of a TP correction intended by a national tax audit, the company must be immediately informed of this correction, so that it can turn to the foreign tax authority and discuss the possibility of a corresponding counter-correction with them. Should the foreign tax authority not agree to such a correction, the taxpayer may apply for a MAP or to the EU arbitration procedure. Further details on MAPs and EU arbitration procedures are set out by the tax authorities in a circular letter of 13 July 2006.

In case of an imminent TP correction intended by the foreign tax authorities, the German taxpayer is obliged to inform the German tax authorities. Should German transfer prices change correspondingly, such changes would have to be documented. Should the German tax authorities not see themselves in a position to effect the corresponding counter-correction, the company has the opportunity to apply for a MAP or EU arbitration procedure in order to avoid double taxation. In case of a foreign TP correction, the company must submit all documents relevant to this correction to the German tax authorities.

It should be noted that, although the success of competent authority proceedings depends on the voluntary consensus of both tax authorities involved, the German authorities are unlikely to reject a compromise. In addition, Germany has begun to include in the negotiation of a new tax treaty the position that MAPs should contain an arbitration element (i.e. that they cannot end without a binding and final decision to avoid double taxation). Like all other EU Member States, Germany observes the European Arbitration Convention on Transfer Pricing Matters. The EU Arbitration Convention is based on the Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Transfers of Profits between Associated Undertakings.

Advance pricing agreements (APAs)

The attitude of the Federal Ministry of Finance on APAs is generally positive, insofar as the Ministry actively welcomes and supports APAs for TP purposes in Germany. This has to be seen against the background that the determination of arm's-length transfer prices in an APA serves the avoidance of lengthy disputes between the participating authorities in treating cross-border transfer prices. A further benefit of an APA is that it may considerably shorten the length of tax audits, because the TP system as such is not challenged. In addition, APA reporting requirements and documents of an APA can be used to fulfil German TPD requirements.

However, it should be emphasised that the Federal Ministry of Finance is typically not prepared to grant unilateral APAs in TP issues because unilateral APAs have no binding effect on the other country concerned. Therefore, the German tax authorities are instructed to grant APAs only on a bilateral or multilateral basis. This necessitates the respective other country to participate in the APA procedure and effecting APA proceedings on the legal basis of Article 25 OECD Model Tax Convention in the sense of a (anticipated) MAP.

Germany also has APA guidelines in the sense of formal regulations on how to apply for, negotiate and grant an APA. On 5 October 2006, Germany's Federal Ministry of Finance released a circular on bilateral and multilateral APAs, which was designed to facilitate the processing of APAs and to establish more certainty for taxpayers.

Within the Federal Ministry of Finance, the competence for APA applications and for granting an APA has been centralised in two departments, while one department handles European cases and the other handles all other cases. These centralised departments are located within the Federal Tax Office in Bonn. It has to be considered that in addition to the Federal Tax Office, the local tax office (including the local tax auditor) is regularly involved in an APA procedure. In addition, expert auditors for international tax issues from the Federal Tax Office are generally involved in the proceedings.

In 2007, Germany introduced the following fees for its APA programme:

- In general, the fee for an APA amounts to EUR 20,000 (basic fee), which becomes due, if an APA is not issued as set out in the application process. In case of multilateral APAs, the fee incurs for each country involved.
- The fee for an extension of an already existing APA amounts to EUR 15,000 (extension fee).
- Amendments to an APA application incur a fee of EUR 10,000 (amendment fee).
- Reduced fees are possible in cases concerning small enterprises.

Finally, the German tax authorities closely examine any unilateral APA granted by a foreign tax authority that has detrimental tax effects in Germany, unless the German tax authorities themselves actively participated in the APA process.

Germany

41.

Ghana

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Overview

In Ghana, transfer pricing (TP) regulations came into force in September 2012 and are applicable from the 2012 year of assessment (the TP regulations). The TP regulations require taxpayers who transacted with other persons with whom they have controlled relationships, to complete annual TP returns at the end of a year of assessment, and submit the same to the Ghana Revenue Authority (GRA). Supporting documentation/information on transactions with connected persons and other company information, which would enable the GRA to establish whether or not such transactions are at an arm's-length price, should be provided alongside the return.

Although the GRA has not started to strictly require implementation of the TP regulations, Ghana has recently seen the GRA requesting some taxpayers to file their TP returns. In addition, in the 2014 budget last year, the Minister of Finance noted that the GRA would conduct TP audits to increase tax revenues, although this is yet to commence. These have raised a need for most taxpayers to conduct TP studies to ensure that they have TP documentation in place to justify the basis of charges in transactions with related parties.

Country	**Ghana**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Annual TP returns to be prepared at the time of filing annual tax returns.

Ghana

Country	Ghana
Must TP documentation be prepared in the official/local language?	TP documentation must be prepared in the official language.
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Penalty of GHS 4 for each day of default for late submission of TP return and where there are TP adjustments, percentage of any additional taxes. for late

Introduction

Ghana introduced the TP regulations in 2012 to provide a more detailed guideline to the otherwise generic TP provisions in the Internal Revenue Act 2000 (Act 592) (IRA).

Generally, the TP regulations follow the Organisation for Economic Co-operation and Development (OECD) TP Guidelines, but with a much broader perspective on the nature of entities and transactions that would be governed under the TP rules of Ghana. In January 2013, the GRA released practice notes on TP, which clearly state that the Commissioner General (CG) will apply the principles contained in the OECD TP Guidelines except where they are inconsistent with the provisions of the TP regulations. It is therefore expected that the OECD TP Guidelines will be relevant in interpreting the Ghanaian TP regulations.

Advance pricing agreement (APA)

The TP regulations do not clearly mention the possibility for a taxpayer to conclude an advance pricing agreement (APA) with the GRA with respect to related-party transactions. Furthermore, the GRA has indicated that in practice they will not enter into APAs. However, a taxpayer may request for a private ruling from the CG of the GRA, regarding the general application of the IRA to certain transactions, either proposed or entered into by the taxpayer, based on the fulfilment of certain conditions.

Legislation and guidance

Transfer pricing in Ghana is governed by the IRA and the TP regulations 2012, which came into force in September 2012. The TP regulations cover any transactions that affect the profit or loss of an entity, which include:

- purchase, sale and lease of goods and any tangible or intangible assets
- provision or receipt of services including management, technical, intragroup services, etc.
- rent, hire and similar charges
- provision of finance and other financial arrangements.

Transactions involving intangible property

The TP regulations contain specific provisions in relation to intangible property. Intangible property has been defined to include licences, sales and any other transfer of intangible property.

The regulations state that the CG shall consider the following in determining the arm's-length conditions between parties in a controlled relationship who are transacting on intangible property:

- Price to be paid by a comparable independent person will be considered together with other factors from the perspective of both parties.
- Usefulness of the intangible property to the business of the transferee.

The comparability principle will be applied after consideration of certain predetermined factors including: expected benefit from the intangible property, geographical limitation, character of the right transferred (inclusive or non-inclusive) and whether or not the transferee has a right to participate in a further development made by the transferor.

Transfer pricing methods

The following TP methods are approved under the TP regulations:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus (CP) method.
- Transaction net margin method (TNMM).
- Transaction profit split method (TPSM).

However, the CG may use or permit a person to use a method other than a method stated above if they are of the opinion that considering the nature of the transaction, the arm's-length price cannot be determined by use of any of the above methods.

Penalties

Taxpayers having transactions with related parties are required to file documentation in respect of the inter-company transactions undertaken in each year as described under the documentation section below. The documentation should be provided as part of the annual income tax return no later than four months after the company's financial year-end. Currently, the penalty for late filing of corporate income tax returns is GHS 4 for each day of default.

In addition, in a transaction between persons who are associates, the IRA gives powers to the CG to distribute, apportion, or allocate inclusions in income, deductions, credits, or personal reliefs between those persons as is necessary to reflect the chargeable income or tax payable, which would have arisen for these persons if the transaction had been conducted at arm's length. Any additional taxes imposed as a result of the TP adjustments results in a penalty of 10% (within the first three months) and 20% (exceeding three months).

Documentation

As stated above, the TP regulations require that taxpayers who transact with other persons with whom they have controlled relationships to complete annual TP returns in a prescribed form at the end of the year of assessment and submit the same to the GRA. Supporting documentation/information on transactions with connected persons and other company information which would enable GRA to establish whether or not such transactions have been priced at arm's length should also be provided.

Some of the information to be provided in the documentation includes:

- The global organisational structure showing the location of each of the related parties as well as the ownership linkages.
- Principal activities of each person involved in the inter-company transaction.
- Details of the inter-company transactions including details of contracts and agreements.
- Functions performed, risks assumed and assets used by each party to the inter-company transaction.
- Business strategies impacting the pricing of inter-company transactions.
- The TP methods applied.
- Justification for the use of the method including any assumptions made.
- The uncontrolled transactions (transactions between persons who are not related) that have been used as a basis for setting the inter-company prices.
- A comparability analysis to show that the uncontrolled transactions are sufficiently similar and can be properly used as a basis for setting or validating the pricing of inter-company prices.
- Any calculations or price adjustment factors considered in setting the transfer prices.
- Segmented financial information to show the business segments impacted by the inter-company transactions.

Transfer pricing controversy and dispute resolution

Transfer pricing audit

On receipt of the returns filed, the CG may examine the amount charged or credited to the final accounts in respect of a transaction to determine whether the amount is within an arm's-length range.

The CG may adjust the taxable profit of a person if after the examination they are satisfied that the amount charged or credited to the final accounts of that person is not within the arm's-length range. In their examination, the CG may select a TP method that they consider appropriate. Presumably, this may lead to objections and counter-objections between the CG and that person or entity until a final assessment is raised.

It is possible to avoid this by seeking a ruling as to the most appropriate method to determine the pricing of a transaction before a contract is finalised between controlled parties.

The filing of an annual TP return is not a prerequisite for an audit of an entity's TP-related transactions by the CG. The CG may conduct an audit of a person even though the person has not filed a return.

We are yet to witness the GRA's TP audits. As stated above, they have however written to taxpayers requesting for the filing of the TP returns in the format indicated on the forms provided.

Risk areas that taxpayers need to be aware of

- Proof of performance of services – taxpayers should be able to provide evidence that services were actually provided.
- Need for services – taxpayers should be able to provide proof that services were actually required by the service recipient and that the services provide a commercial benefit to the recipient.
- Duplication – where taxpayers have employees providing similar services, GRA challenges these service fees (e.g. a management fee for finance function support will be challenged if the local company has a finance team of its own).
- Service fees charged as a percentage of turnover – GRA argue that management fees that are based on a percentage of turnover are not appropriate, since it does not happen in third-party situations that a company will remunerate a service provider based on a percentage of turnover.
- Intellectual property and loss-making companies – subsidiaries of multinationals that consistently report losses are considered high risk (as the tax authorities assume this is TP induced) and will usually be subjected to detailed TP examination.

Comparison with OECD Guidelines

In general, the TP regulations in Ghana follow the OECD TP Guidelines.

Ghana

42.

Greece

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Overview

During July 2013, two major acts of legislation concerning the Greek tax system were enacted: L. 4172/2013 introduced the new Income Tax Code (ITC), while L. 4174/2013 introduced a new code referring to all tax procedures relating to most administrative aspects of taxation (tax registration and returns, tax audits, penalties, etc.). With few exceptions, both new codes are applicable as of 1 January 2014 and include relevant transfer pricing (TP) provisions, analysed in the following sections.

It should be noted that the double tax regime where TP was regulated by the Ministry of Development and the Ministry of Finance is no longer applicable. L. 4223/2013, which amended both L. 4172/2013 and L. 4174/2013, specifies that TP documentation files for the accounting periods 2008–2009, which have been submitted to the Ministry of Development will be audited by the Ministry of Finance.

Country	**Greece**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	On a yearly basis
Must TP documentation be prepared in the official/local language?	Yes (only as concerns the Greek TP file)
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the transactions' value

Greece

Introduction

Greek TP legislation adopts the arm's-length principle and is consistent with the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.

Legislation and guidance

Transfer pricing adjustment

By virtue of Article 50 of L.4172/2013, when transactions are entered into between domestic enterprises or between a foreign and a domestic enterprise with financial terms different than those that would have been agreed between unrelated parties, the profits that would have been achieved and were not, because of these terms, are considered profit of that company to the extent that they do not reduce the amount of the tax due.

Affiliated undertakings

According to Article 1 of L. 4172/2013, the term 'affiliated persons' is defined as follows:

- They are associated, due to the participation of a company in another company by owning directly or indirectly, equity, shares or participation in capital of at least 33%, based on either value or number, or rights to profits, or voting rights.
- They are associated with any other company owning directly or indirectly, equity, shares, voting rights or participation in capital of at least 33%, based on either value or number, or rights to profits or voting rights in one of the affiliated companies.
- They are associated with any other person (individual or legal entity) with which there is a relationship of direct or indirect substantial administrative dependence, or control, or the person (individual or legal entity) exercises a dominant influence, or has the power to exercise a dominant influence on the decision-making of the company, or in case the two entities have a relationship of direct or indirect substantial administrative dependence, or control, or the power of a dominant influence from a third person.

Permanent establishments (PEs) explicitly fall within the scope of the definition of affiliated undertakings.

Exemptions from transfer pricing documentation requirements

An exemption from maintaining a TP documentation file is provided, if:

- the transactions or transfer of operations amount to up to 100,000 euros (EUR) annually and in total, in case the turnover of the liable party does not exceed the amount of EUR 5 million per tax year, and
- the above transactions or transfer of operations amount to up to EUR 200,000 annually and in total, in case the turnover of the liable party exceeds the amount of EUR 5 million per tax year.

In determining turnover, the amount taken into consideration is the higher of i) turnover based on local tax legislation, and ii) if application of IFRS is mandatory, the amount that corresponds to the turnover included in the group's consolidated financial statements.

Further management fees comments
By virtue of Article 21 of the L. 4172/2013 and as from 1 January 2014 the deductibility of expenses is permitted, to the extent that: i) the expenses were realised for the benefit of the enterprise or in the frame of its usual business activities, ii) the expenses related to an actual transaction and the value of the transaction is not considered lower or higher than the actual value thereof as determined on the basis of the indirect tax audit method, and iii) the expenses are recorded in the accounting books of the period in which they were realised and that the expenses are evidence by the respective documents. In this respect, management fees may be recognised as tax-deductible items, provided that the above conditions are met. Further to the above and on the basis that the Greek TP legislation adheres to the OECD Guidelines, the Greek Tax Authorities (GTA) when examining the deductibility of these fees are expected to: i) determine the type of services, ii) evaluate whether there is a benefit for companies receiving such services by testing the contribution of the services to the domestic company's turnover growth, and iii) to examine the allocation method in order to evaluate whether management fees meet the arm's-length principle. Finally, it is to be noted that important limitations have been introduced on the tax-deductibility of fees paid to companies established in countries considered as 'non-cooperating states' or 'states with a preferential tax regime'.

Transfer pricing methodologies
The Ministry of Finance's regulations outline the acceptable TP methodologies. Fundamentally, these replicate the provisions of the OECD Guidelines, to which there is a direct reference; however, the Ministry of Finance's regulations place a priority on the comparable uncontrolled price (CUP) method over other TP methodologies. The hierarchical order of TP methodologies that may be used, as established by the Ministry of Finance's regulations are the following:

- Comparable uncontrolled price (CUP) method.
- Other traditional methods (i.e. resale price method [RPM] and cost-plus method [CPM]) – available only where the CUP method cannot be applied.
- Other (non-traditional) methods (i.e. transactional net margin method [TNMM] and profit split method [PSM]) – available only if the three traditional methods cannot be used.

To apply a method lower on the hierarchy, the taxpayer must include in the documentation file a clear explanation of the reasons why a higher placed method cannot be applied.

Calculation of the arm's-length range
Pursuant to the practice followed so far, when calculating an arm's-length range from comparable company data, the average results of the past three years will be used.

When, by applying one documentation method, a range has been established, then any price falling within the interquartile ranges is considered as compliant with the arm's-length principle.

Anticipated developments in law and practice
The Ministry of Finance is expected to issue further regulations in the future.

Moreover, as Greek TP audit experience develops in the coming years, practical application of the new legislation is also likely to become clearer.

Use and availability of comparable information

As the CUP method has the highest status in the Ministry of Finance's legislation, evidence of internal and external comparable data should be included in the documentation file, if available. To demonstrate the comparability of such transactions with the inter-company transaction, the taxpayer must provide sufficient internal data, such as sales volume and units sold, for such an analysis to be made.

When reviewing comparable data provided by a taxpayer (including internal and external comparables, as well as comparables taken from databases), a detailed comparability analysis of the characteristics of the transaction being tested and the parties to the transaction should be provided. The factors considered important in this analysis are largely consistent with the comparability factors identified in paragraphs 1.19–1.35 of the OECD Guidelines.

The TP regulations permit the use of commercial databases to collect comparable data. In such cases, the Greek taxpayer must provide an accurate description of the database, the criteria and steps used to select the comparable companies, and a list of all the companies that were eliminated from the search (and the reasons for their elimination). It is understood that the Greek authorities of the Ministry of Finance have also licensed commercial databases themselves, for the purposes of conducting comparable searches.

Thin capitalisation

Based on Article 23 of L. 4172/2014, interest expenses arising from loans granted to a company by a third party, other than bank loans, shall not be deductible to the extent that they exceed the interest that would have accrued should the interest rate be equivalent to that of current accounts to non-financial corporations, as this is determined by the Bulletin of Conjunctural Indicators of the Bank of Greece, taking into account the most recent period prior to the date of borrowing.

Intra-bank lending and bond loans issued by Greek *société anonymes* (public limited companies) are explicitly excluded from the scope of the above article.

As per the thin capitalisation rules introduced in Article 49 of the L. 4172/2014, any interest expense will not be recognised as a tax-deductible business expense to the extent that the excess interest expense exceeds the 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA). Said profits are determined, based on the financial statements drafted by virtue of the Greek accounting rules, taking also into account the tax adjustments stipulated in the Greek Income Tax Code.

It should be noted that a transitional period has been introduced from 1 January 2014 to 31 December 2016; more specifically the non-deductible interest expense should be calculated at the following percentages of EBITDA:

- 60% for the fiscal year starting 1 January 2014.
- 50% for the fiscal year starting 1 January 2015.
- 40% for the fiscal year starting 1 January 2016.

Furthermore, it is explicitly specified that the aforementioned limit does not refer to net interest expenses that do not exceed the amount of EUR 5 million, while from 1 January 2016 this amount is reduced to EUR 3 million.

Any excess amount of non-deductible interest expenses is from now on carried forward indefinitely and therefore will be deductible in future years, to the extent that those future years will indicate an uncovered EBITDA amount.

Other regulations

Tax regime of L.3427/2005

L. 3427/2005 provides a specific advantageous tax regime for companies offering services to their parent companies established abroad.

Specifically, according to Article 30 L. 3427/2005, Greek companies or branches of foreign companies may be subject to this regime, provided that they offer exclusively the following services to their foreign parent company or affiliates:

- Consultancy services.
- Central accounting services.
- Production, product, process or services' quality control.
- Drafting of studies, designs and contracts.
- Advertising and marketing services.
- Data processing.
- Collection and provision of information research and development.

Companies operating under the regime of L.3427/2005 merely recharge all of their costs, adding a predetermined mark-up and are taxed on their profits under the regular corporate income tax (CIT) rate. All costs recharged are considered as tax-deductible. The mark-up on cost is preapproved by the competent department of the Ministry of Development, which examines a benchmarking study prepared by the company for that purpose. The relevant decision is valid for five years. Companies operating under the said regime are excluded from the obligation to document compliance with the arm's-length principle.

Non-cooperative states and states with preferential tax regime

The definition of states with a 'preferential tax regime' is amended and the issuance of an annual list including the states with a preferential tax regime is introduced by L. 4172/2013.

A state with a preferential tax regime is defined as a state in which the tax on profits or income or capital is equal to, or lower than, a percentage of 50% of the CIT rate that would be due according to the provision of Greek tax legislation, if the beneficiary of said income was tax-resident or maintained a PE in Greece. The issuance of a list of states with a 'preferential tax regime' by a decision of the Minister of Finance, which will be published in the Government Gazette in January of each year, is provided.

By issuing a list of the states with a preferential tax regime at the beginning of each year, the uncertainty regarding the states that may be characterised as such by the tax authorities and particularly following the completion of the relevant transactions, especially taking into account that the definition remains particularly vague, is somehow mitigated.

Penalties

Failure to comply with documentation requirements

The penalties for the delayed submission or non-submission of the summary information table (SIT) or the transfer pricing documentation file (TPDF) are presented below:

- For the delayed submission of the SIT and of the TPDF the penalty is calculated at a percentage of 1/1000 of the declared gross profits (not below EUR 1,000 and not exceeding EUR 10,000).
- For non-submission of the SIT or not providing the TPDF or incomplete or insufficient content, the penalty is calculated at a percentage of 1/100 of the declared gross profits (not below EUR 10,000 and not exceeding EUR 100,000). The TPDF is considered as incomplete or insufficient if it is impossible for the tax authorities to validate the correctness or the documentation of the transfer prices, despite any further information provided within the course of the audit.
- For repetition within five years of the first infringement, the penalty equals double the initial penalty.
- For second repetition within five years from the first, the penalty equals quadruple the initial penalty.

The penalty imposed in cases of non-submission of the SIT TP information will also be imposed in cases of inaccurate or incomplete TP information being included in the information table.

Failure to comply with the arm's-length principle

In the event where during the tax audit a company is found not to be compliant with the arm's-length principle, any difference will increase its taxable base for income-tax purposes as well as other tax obligations.

Articles 58-61 of the new L. 4174/2013, which introduces a new code referring to all tax procedures, provides for the following penalties applicable in case of violations of the arm's-length principle:

Infringement	Penalty
Inaccurate tax return with a difference in tax of 5%-20%	10% on the amount of the difference between the tax assessed on the basis of the tax return and the corrective tax assessment
Inaccurate tax return with a difference in tax of 21%-50%	30% on the amount of the difference
Inaccurate tax return with a difference in tax exceeding 51%	100% on the amount of the difference

Documentation

Generally, the concept of the TP documentation follows the concept of the master and local TP file (TPDF) of the EU Transfer Pricing Code of Conduct. Article 50 of L. 4172/2013 as well as Ministerial Decision POL. 1144/2014 makes explicit reference to the OECD Guidelines.

The TPDF should be available and respectively updated within four months from year-end. The TPDF should be revised and updated annually. If the taxpayer proves that

the conditions of its operations have remained unaltered, then the comparable data retrieved from a database can be used for three consecutive fiscal years to the extent that the financial data are updated annually.

The TPDF is accompanied by a SIT of transfer pricing information, which is submitted electronically to the General Secretariat of Informative Systems (GSIS) of the Ministry of Finance annually and within four months from year-end. The TPDF is kept at the registered seat of the liable party for the whole time period that the books and records are required to be kept, and should be provided at the disposal of the Greek Tax Authorities (GTA) within 30 days from the receipt of the relevant request.

It should be noted that according to Article 51 of L. 4172/2013, it is explicitly provided that every business reorganisation/restructuring that consists of transfer of operations, assets, risks or business opportunities, and is realised by, or involves related entities, should be made according to the arm's-length principle. Specifically, it is provided that the transfer or the granting of a right to use goodwill or intangible assets that result from business restructurings should be made in return for a consideration, according to the arm's-length principle and taking into consideration the total value of the transfer package deal. The imposition of adjustments is provided in case of the inability of the taxpayer to document the non-transfer or grant of right to use of material intangible assets, or assets, or the payment of an arm's-length consideration.

This provision significantly broadens the frame of application of tax rules in case of intragroup restructurings, which until today were covered quite insufficiently by the provisions on the transfer of business. However, the broadness of the framework may entail risks of legal uncertainty, mainly in view of the practical application by the GTA.

Contents of documentation

The TPDF should include the following:

- Information regarding the group (master documentation file):
    - Organisational, legal and operational structure (including PEs and partnerships).
    - Group corporate activities and strategy including changes from the previous fiscal period.
    - Inter-company TP policy, if available.
    - Identification of inter-company transactions including nature of transactions (e.g. sale of goods, provision of services), invoice flow, transaction amount and information about the related parties engaged in the transaction (e.g. their objectives, duration of trading activity, annual gross income, number of employees).
    - Functions, risks and assets of the related parties including changes from the previous fiscal period.
    - Ownership of intangible assets and associated royalty payments to, or from, third parties.
    - Cost contribution agreements (CCAs) and advance pricing agreements (APAs) between the companies of the group and foreign tax authorities as well as court decisions regarding the group's TP policy.
    - Description of the inter-company transactions that took place within the fiscal year with parties with which the liable party became affiliated or ceased the affiliation during the same fiscal year in order to be used as comparables, on the condition that the comparability factors are met.

- Information regarding the company (Greek documentation file):
  - Detailed report of the inter-company transactions covered by the documentation including nature of transactions (e.g. sale of goods, provision of services), invoice flow and transaction amount; description of extraordinary transaction or of circumstances deriving out of business restructurings.
  - Especially in the event of an inter-company transaction of sale/purchase or transfer of intangibles, further information regarding the compliance with the arm's-length principle.
  - A comparative analysis showing the characteristics of the inter-company transactions, a functional analysis of the relevant related parties, the contractual terms of the transactions, the economic circumstances surrounding the transactions and any special corporate strategies.
  - Description of the TP method or methods adopted for the inter-company transactions including the reasons why that method was considered most appropriate.
  - Information related to internal or external comparables, where available.
  - Commitment of the liable party to have at the disposal of the tax authorities, upon their request and within considerable time, any further information related to its TP policy.
  - Justification of any TP adjustment(s).
  - Explanation and detailed justification of any adjustment(s) made to the comparable data.
  - Further information on inter-company transactions with related parties that are established, or have their tax residence in a non-cooperative state along with their financial data.
  - Copies of inter-company agreements.

The TPDF could be maintained in an internationally acceptable language (preferably English), whereas the Greek documentation file must be maintained in the Greek language.

Transfer pricing controversy and dispute resolution

Tax audit procedures and tax certificate process

Within the course of an ordinary tax audit the documentation file should be available; the taxpayer has, in any case, 30 days at their disposal to make the TPDF available to the tax authorities.

However, recent developments have occurred in Greece regarding the tax audit procedure, the so-called Tax Audit Certificate.

Specifically, Greek companies with year-end closing after 30 June 2011 are obliged, in the course of their audit by certified auditors, to be audited also from a tax perspective. The audit programme of the tax certificate includes the fulfilment of the company's obligations with TP requirements set by the tax law – what has happened in essence is that the tax audit has been outsourced from the public domain to certified auditors after the latest developments of the Greek economy.

At least 9% of the total number of companies audited by individual certified auditors and audit firms for their tax compliance will be selected for an audit by the tax authorities. The criteria for selection are not set yet. These audits to be carried out by the relevant tax audit authorities should be completed no later than eighteen (18)

months following the deadline for submission by the certified auditors and audit firms of the Tax Compliance Report in the relevant database. Apart from companies audited under the above conditions, the Ministry of Finance may choose to audit additional companies under certain conditions; *inter alia* violations related to TP matters are one of the situations where the Ministry of Finance may choose to audit a company.

So, all regular audits, other than the exceptions mentioned in the paragraph below, are conducted within the aforementioned eighteen (18)-month period. Exceptionally, regular audits carried out in cases where Articles 50 of L. 4172/2013 and 21 of L. 4174/2013 is violated, the audit may be performed until the expiry of the statute of limitation for that fiscal period, which is five years.

To summarise, the above 18 months' period implies that the audited company received an unqualified tax certificate. Within 18 months from the issuance of the Unqualified Tax Compliance Report and provided that no tax violations have been identified through the sample based audits by the Ministry of Finance referred to above, the tax audit of this fiscal year is considered finalised.

In the event that a TP violation has been deemed to occur, a mandate will be issued and the audit from the tax authorities may be performed until the expiry of five years' statutory limitation, provided by Article 84 of L. 2238/1994.

Furthermore, for fiscal years commencing from 1 January 2014 onwards, Article 65A of the newly introduced L. 4174/2013 refers to the tax certificate that public limited companies (SAs) and limited liability companies (LLCs) and branches of foreign enterprises receive.

The provisions of the said article reduce the penalties that are imposed to the liable companies for which no tax certificate is issued. The respective penalties are now calculated between EUR 5,000 and EUR 40,000, depending on the gross income of the audited tax year.

It derives from the wording of the law, which from now on the non-issuance of a tax certificate or the detecting of infringements of the tax legislation constitutes a criterion for the election by the tax administration of cases subject to audit.

Revised assessments and the appeals' procedure

A taxpayer has the possibility to contest the assessment of the GTA and commence litigation within the deadline for submission of the relevant request to the relevant administrative courts.

L. 4174/2013 provided for the filing of an out-of-court petition by the taxpayer for the review of the tax assessment act issued by the tax administration by the Department of Internal Review, in case the content of the tax assessment act is questioned within a deadline of 30 days from the notification of the act.

The competency of the new directorate includes the review of the silent negative acts of the tax administration, which are effected as from 1 January 2014 onwards.

The law provides for a suspension of payment of 50% of the assessed amount. Payment of the remaining 50% may be the subject of further administrative suspension if this is granted by the Directorate for Dispute Settlement following an application by the taxpayer.

It is provided that in case of cancellation of the contested act by the new directorate, the tax authority issues a new act, according to the decision of the Directorate for Dispute Settlement.

It is specified that a silent rejection of the out-of-court petition takes place at the lapse of the 60-day (exceptionally, 120-day) deadline for the issuance of a decision and not of the deadline for the notification of the act.

If a suspension of payment of 50% of the disputed tax is granted, the taxpayer is not exempt from interest on late payment. There is no additional late payment under L. 4174/2013.

Resources available to the tax authorities

The Ministry of Finance continues to provide training in TP matters to its existing pool of tax auditors, and TP issues are therefore likely to be raised in future corporate tax audits. However, as with any country introducing TP legislation, a 'ramp-up' period during which the tax auditors gain experience in the area of TP is anticipated.

Legal cases

Given that no assessments in relation to TP issues have arisen in Greece as yet, there are no particular legal precedents at this time.

Burden of proof

The burden of demonstrating compliance with the documentation requirements of Articles 50 of L. 4172/2013 and 21 of L. 4174/2013, introducing the obligation to file a TP file, an arm's-length pricing analysis and any extenuating circumstances justifying a deviation from such arm's-length pricing (such as a market entry business strategy) upon relevant request from the authorities, rests with the taxpayer. However, once a taxpayer has demonstrated such *prima facie* compliance, the burden of rebutting and proving either i) lack of compliance, ii) failure to meet the arm's-length standard, or iii) failure to sufficiently demonstrate extenuating circumstances, rests with the GTA.

Risk transactions or industries

Based on our experience gained from the companies that have already received a notification letter from the Ministry of Development in May 2010, which was then the competent authority, the targeted transactions or industries consisted of a wide range of activities (e.g. consumer goods, services).

Limitation of double taxation and competent authority proceedings

Greece has an extensive treaty network including treaties with almost all its major trading partners. These treaties contain provisions to relieve double taxation through the use of mutual agreement proceedings (MAPs); however, to date, it is not known whether Greece has conducted any such negotiations.

Technically, there are no restrictions on the commencement of an application for a MAP, following an audit assessment. Consequently, it is not necessary for the taxpayer to have exhausted its rights through the domestic appeals' process of the administrative courts in order to have the right to apply for a MAP.

Advance pricing agreements (APA)
The option of obtaining an APA of the methodology of specific future intragroup transactions with related parties is integrated in the Code of Tax Procedures. The object of the APA constitutes the total of the criteria used for the determination of the prices of intragroup transactions during a specific time period, which include mainly the TP methodology used, comparable or reference data, and the respective adjustments, as well as the critical assumptions on future developments. The object of the APA may constitute every other specialised matter concerning the pricing of transactions with related parties.

It is provided that the validity of the APA cannot exceed four years, while it cannot enter into force retroactively (tax year that has lapsed at the time the application for the APA has been submitted). The issuance of the APA decision therefore does not prevent subsequent application for mutual settlement procedure, assuming that the time limits set out in the relevant double tax treaty are adhered to.

It is provided that the APA decision may be revoked or cancelled by a decision of the tax administration, provided that the legal conditions are met.

Joint investigations
No joint investigations have taken place between the GTA and any other tax authorities to date. However, no law or regulation prevents Greece from conducting such a joint investigation in the future.

Liaison with customs' authorities
With the lack of TP focus in Greece in the past, there has historically been no liaison between the tax authorities and the customs' authorities in this area. However, there is no administrative requirement that Government bodies maintain taxpayer confidentiality between themselves and, as a result, it is possible that such liaison may develop in the future.

Comparison with OECD Guidelines
Greece is a member of the OECD, and the provisions of Articles 50 and 51 of L. 4172/2013 and Articles 21 and 22 of L. 4174/2013 and the Ministry of Finance regulations are all largely consistent with the OECD Guidelines.

Greece

43.

Guatemala

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Overview

From a Guatemalan transfer pricing (TP) perspective, the application of the arm's-length principle reaches any operation carried out between a local and a foreign-related entity. Local legislation allows the selection of traditional methods and profit-based methods that are consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines as well as an additional method (sixth method) applicable to the imports and exports of commodities. Advance pricing agreements (APAs) are permitted, and the Guatemalan tax authority (SAT) can reclassify activities according to its true nature, according to the Guatemalan Tax Code.

Country	**Guatemala**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes*
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Before annual income tax return is due (March 31)
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes

Guatemala

Country	Guatemala
How are penalties calculated?	Fines of 625 to 1,250 United States dollars (USD) the first and second time that documentation is required and is not submitted, third time and onwards 1,250 USD and 1% on gross income filed in the last Income Tax Return.

*Five OECD methods were adopted by Guatemalan legislation and an additional method (so called the sixth) for valuing imports and exports' transactions of commodities was adapted from other South American legislation.

Introduction

Transfer pricing regulations were issued by the Guatemalan Congress through Book I of the Tax Update Law (TUL) in February 2012. This law states that TP rules will be effective in Guatemala as of 1 January 2013. In October 2013, SAT made available a hyperlink on its website, which enables taxpayers to submit electronic information of transactions carried out with foreign related parties.

On 20 December 2013, decree number 19-2013 was published in the Official Gazette of Guatemala. This decree contains multiple tax law amendments including the suspension of effectiveness of the TP rules until 1 January 2015. Although the tax reform was not explicit about effectiveness for FY 2013, due to the amount of time that it was enforced and due to the fact that the tax laws in Guatemala cannot have a retroactive effect, there were various interpretations of this issue; many tax specialists thought that the TP rules should have been applied in FY 2013, while others argued for the suspension until 2015.

In February 2014, the Guatemala Tax Administration announced the institutional criteria regarding the effectiveness of the TP rules for FY 2013. Concerning this, the Tax Administration stated that the logical-legal arguments that led them to state its criteria on the application of the rules for 2013 were primarily the following:

- The non-retroactivity of the law and, as a result, the non-retroactive effects of the suspension.
- The consideration of the time period during which the TP rules were in effect in 2013.

The Guatemalan Tax Administration argues that TP rules apply for FY 2013 and based on this premise, they are entitled to require an adequate TP analysis.

Legislation and guidance

Guatemalan TP rules are based on the internationally accepted arm's-length principle. This legislation does not refer explicitly to the OECD Guidelines. However, the accepted methods by Guatemalan rules are consistent with those contained in these Guidelines.

Sections 59 and 60 of the TUL introduce the TP methods including the:

- Comparable uncontrolled price method.
- Cost plus method.
- Resale price method.
- Profit split method.
- Transactional net margin method.
- Valuation method applicable for imports and/or exports of commodities.

On 1 January 2013, Guatemala introduced a tax amendment through TUL sections 54 to 67, which contains the so-called 'special valuation rules for related parties', which regulate transfer prices agreed between related companies in respect of their inter-company transactions.

Documentation

According to sections 65, 66 and 67 of the TUL, taxpayer documentation must contain:

- documentation relating to the group to which the taxpayer belongs, and
- documentation on the taxpayer itself.

Section 58 of the TUL includes a comparability criteria which states that companies or transactions are comparable when none of the differences (if any) between the situations compared could materially affect the price or profit margin, and that reasonably accurate adjustments can be made to eliminate the effect of such differences. In order to determine those differences, the required elements that must be considered include the following:

- Characteristics of the operations.
- Functions or operations including the assets used and risks assumed by each of the parties involved.
- Contractual terms.
- Economic circumstances.
- Business strategies, which refer to market penetration, permanence and expansion schemes.

Transfer pricing controversy and dispute resolution

The Guatemalan Tax Administration has begun to create a database through which it has required among other information, the following:

- Information on the shareholders of local companies.
- Investments that these companies have in foreign companies.
- The usual type of transactions carried with foreign-related parties.

During 2013 and 2014 SAT did not request any supporting documentation about observance of the arm's-length principle in transactions with foreign-related parties. Notwithstanding SAT is training a team of professionals in the process of TP audits and has a section of standards development and best practices that is constantly gathering experiences of other tax administrations so that they can implement more effective procedures which can be put in place when TP audits begin.

On February 2014, SAT announced a new Income Tax Return form in which taxpayers would be required to disclose whether they had performed transactions with related parties abroad during FY 2013.

During the first quarter of 2015, SAT continued requesting information about operations of taxpayers categorised as ‘special’ ones (category based on an income/ kind of transactions performed basis). In addition taxpayers who indicated in the Annual Income Tax Filing 2013 that they had transactions with related parties, they had been advised by SAT to properly document those transactions through the corresponding TP study for FY 2015.

Additionally, the Tax Administration stated that during the second half of 2014 it will be requesting TP documentation for FY 2013. In the event that the taxpayer has the proper supporting documentation that its transactions with related parties abroad were conducted under the observance rules of the arm’s-length principle, the burden of proof lies with the tax administration, which must examine and take issue with the documentation submitted by the taxpayer. Otherwise, if the taxpayer does not supply the proper supporting documentation, the tax authorities will carry out their own analysis and enforce adjustments, if necessary, so that the taxpayer’s transactions reflect a proper market value, and in such case the burden of proof will fall on the taxpayer, who must challenge the analysis of the tax administration using administrative and judicial resources that the law grants them.

Advance pricing agreements
Guatemalan law provides taxpayers with a statutory right to seek APAs. The general regulations are contained in section 63 of the TUL, which regulates in detail the procedure for processing and deciding on APAs between related parties.

Comparison with OECD Guidelines
Guatemala is not a member of the OECD; nonetheless, TP regulations adhere to OECD Guidelines.

44.

Hong Kong

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Overview

Transfer pricing (TP) has been, and continues to be, an important tax issue in Hong Kong, particularly in the context of recent global initiatives on base erosion and profit shifting (BEPS) and Hong Kong's unique source-based taxation framework, as well as increasing cross-border activities of HK-based or foreign-based multinational companies with operations in Hong Kong.

The Inland Revenue Department (IRD) relies on generally accepted accounting principles (GAAP), IRD guidance on TP and provisions in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines to resolve TP issues. Therefore, while Hong Kong is not a member of the OECD, the developments relating to TP within the BEPS framework is expected to affect Hong Kong taxpayers in line with the latest international TP standards.

Of immediate concern to the IRD is the Chinese and Hong Kong Special Administrative Region Government's commitment to adopting the Common Reporting Standard (CRS) and automatic exchange of information (AEoI) as China and Hong Kong will be expected to carry out their first information exchange in 2018. In Hong Kong, the form of the legal framework is under public consultation (as of 1 May 2015) and yet to be finalised, however the development demonstrates the IRD's commitment to act in line with the trend to reinforce international cooperation in tax matters and improve tax information transparency. With the general global developments pertaining to BEPS and transparency, we expect that there will be increased scrutiny on TP matters for Hong Kong taxpayers.

Country	**Hong Kong**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes

Hong Kong

Country	Hong Kong
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	No specific guidance on timing
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Potentially up to 300% of underpaid tax

Introduction

The increasing cross-border activities of Hong Kong businesses with those in mainland China and the expansion of the Hong Kong treaty network have made TP a real issue to contend with in Hong Kong. In April 2009, the IRD issued DIPN 45 on Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments (DIPN 45). This was followed by the long-awaited DIPN 46 on Transfer Pricing Guidelines – Methodologies and Related Issues, published in December 2009. Both of these practice notes seek to provide taxpayers with greater guidance and clarity in the area of TP. In addition to DIPN 45 and DIPN 46, the decision made by the Court of Final Appeal (CFA) in July 2009 in the Ngai Lik case (Ngai Lik Electronics Company Limited vs. Commissioner of Inland Revenue), which is discussed in more detail later in this chapter, contains significant TP implications. In March 2012, the IRD issued DIPN 48 on advance pricing arrangements, which introduced the APA programme to Hong Kong taxpayers with guidance on the regime. These developments have shaped the TP landscape in Hong Kong. Transfer pricing has become an increasingly important tax issue in Hong Kong.

Legislation and guidance

Statutory rules

Section 20(2) of the Inland Revenue Ordinance (IRO) is the only statutory provision that can be considered as enacted to deal with TP issues in Hong Kong. This section applies where a resident person conducts transactions with a 'closely connected' non-resident person in such a way that if the profits arising in Hong Kong are less than the ordinary profits that might be expected to arise, the business performed by the non-resident person in pursuance of their connection with the resident person shall be deemed to be carried on in Hong Kong, and the non-resident person shall be assessable and chargeable with tax in respect of their profits from such business in the name of the resident person.

The main thrust of IRO section 20(2) is to ensure that any transactions a Hong Kong resident has with a closely connected non-resident are conducted in a reasonable manner, as if transacting with a third party in accordance with the arm's-length principle.

Section 20(2), however, has historically been perceived as having limited practical application. Advance Ruling Case 14 and Case 27 are rare examples that demonstrate how the IRD applies this section in practice. The IRD has often been more inclined to use other provisions in the IRO including the general anti-avoidance provisions, to deal with TP issues, particularly if the potential amount involved was significant. For example, the IRD has historically sought to make TP adjustments by:

- disallowing expenses incurred by the Hong Kong resident under IRO sections 16 or 17
- bringing the non-resident taxpayers into tax under IRO section 14 (and thereby taxing both sides of the related-party transactions), and
- challenging the entire arrangement under general anti-avoidance provisions such as IRO section 61A (allowing the IRD to disregard or to counteract the mispriced transactions).

Disclosure requirements

To combat abusive tax schemes used by corporations with tax evasion/avoidance as the primary motivation, the key focus of the IRD is the identification and investigation of questionable transactions. The IRD achieves this through the scrutiny of the annual profits tax return, a statutory form specified by the Board of Inland Revenue under IRO section 86 for a taxpayer to fulfill their profits tax reporting obligation. Taxpayers are required to disclose in the annual profits tax return the following matters:

- Transactions for/with non-resident persons
- Payments to non-residents for use of intellectual properties
- Payments to non-residents for services rendered in Hong Kong, and
- Transactions with closely connected non-resident persons.

Other official guidance

The IRD releases DIPNs to provide guidance to taxpayers on a variety of issues as well as clarification of existing positions. These publications are not legally binding; they do, however, provide the IRD's view on the existing law and its administrative practices in its application of the law. The issuance of DIPN 45 and DIPN 46 was the first time that the IRD explicitly expressed its view in dealing with TP-related matters. Since these practice notes represent the existing view of the IRD, they are retrospective in nature and should apply to taxpayers' historical, current and future TP arrangements. DIPN 45 and DIPN 46 are summarised as follows:

DIPN 45

DIPN 45 provides guidelines on corresponding TP adjustments in the double taxation arrangement (DTA) context. Hence, DIPN 45 applies adjustments only to transactions between a Hong Kong entity and an entity in a jurisdiction that has entered into a DTA with Hong Kong. DIPN 45 stipulates that if a taxpayer has a TP adjustment in one of the treaty countries that has led to double taxation, the IRD will consider allowing the taxpayer to make a corresponding adjustment in Hong Kong, provided the IRD considers the adjustment made in the other country is reasonable. To date (as of 1 May 2015), 32 countries have concluded full-scope DTAs with Hong Kong (i.e. not restricted to airline and shipping income): Austria, Belgium, Brunei, Canada, China, Czech Republic, France, Guernsey, Hungary, Indonesia, Ireland, Italy, Japan, Jersey, Korea, Kuwait, Liechtenstein, Luxembourg, Malaysia, Malta, Mexico, Netherlands, New Zealand, Portugal, Qatar, South Africa, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and Vietnam.

DIPN 46
DIPN 46 outlines the IRD's views of the legal framework for the IRD to deal with TP issues, the methodologies that taxpayers may apply and the documentation that taxpayers should consider retaining to support their arrangements. DIPN 46 also provides some thoughts on TP-related issues, such as tax-avoidance schemes, in particular:

- DIPN 46 explains the relevant provisions (sections 16(1), 17(1)(b), 17(1)(c) and 61A) in the IRO and the relevant articles in DTAs that allow the IRD to make TP adjustments. Note that, contrary to the obiter (i.e. non-precedential) views expressed in the CFA judgment in the Ngai Lik case, to be discussed in the next section, the IRD believes that it can use the deductibility provisions of the IRO (sections 16 and 17) to challenge TP arrangements, which creates a degree of uncertainty in this area.
- DIPN 46 explains the definition of an associated enterprise under the OECD Model Tax Convention, which is relevant for TP in a DTA context. It specifically states that no threshold (e.g. percentage ownership criteria) has been prescribed to define an associated enterprise from a Hong Kong TP perspective. As a result, taxpayers are advised to take a broad definition of associated enterprises when identifying and assessing related-party transactions.
- DIPN 46 confirms that TP in Hong Kong applies to domestic and international-related-party transactions. For TP adjustments made by, or in respect of, non-DTA countries and in respect of domestic-related-party transactions, it is worth noting that no mechanism is currently in place to obtain double taxation relief.
- DIPN 46 explains the OECD Guidelines in the Hong Kong context, in particular, the way the OECD TP methodologies would be applied in Hong Kong under the IRO. However, the IRD indicates a preference for the traditional TP methods in DIPN 46, whereas the draft OECD position2 puts all TP methods on an equal footing. This may imply that TP documentation prepared based on the OECD Guidelines may not always be accepted by the IRD.
- DIPN 46 encourages the preparation of contemporaneous TP documentation. Although the IRO does not mandate the preparation of TP documentation, taxpayers are required to maintain sufficient documents to substantiate their compliance with the arm's-length principle (as per 2010 OECD TP Guidelines) under section 51C of the IRO. DIPN 46 also provides guidance on the type of information that is useful to maintain.
- DIPN 46 provides guidance on services in a related-party context. Generally, principles defined by the OECD are accepted by the IRD. However, DIPN 46 provides no guidance on safe harbours in respect of appropriate mark-ups for intragroup services and TP practices for cost-sharing arrangements.

Legal cases
Ngai Lik case
Though the Ngai Lik case was primarily an anti-avoidance case, the CFA's decision in the case has brought about TP implications for taxpayers engaged in offshore-related-party transactions. The case involved a reorganisation scheme of the taxpayer's group. After the scheme, profits were shifted to related British Virgin Islands (BVI) entities that were newly set up and had related-party transactions with the taxpayer. The IRD considered that the scheme was entered into by the taxpayer with the sole or dominant purpose of obtaining a tax benefit, contrary to the anti-avoidance provisions of section 61A, and assessed the profits of the BVI entities as those of the Hong Kong taxpayer under section 61A. The CFA, however, held that the section 61A assessments raised

by the IRD in this case were not validly raised, because they were based on arbitrary amounts rather than counteracting the tax benefit obtained by the taxpayer from its TP arrangements. The CFA ordered that the assessments under section 61A be raised on the basis of a reasonable estimate of the assessable profits that the taxpayer would have derived if it had hypothetically dealt with its related parties at an arm's-length price.

In addition, a clear but obiter part of the CFA judgment stated that the wording of the expense deduction sections of the IRO, sections 16(1), 17(1)(b) and 17(1)(c), would not authorise the IRD to disallow the deduction of amounts expended for the purpose of producing chargeable assessable profits simply on the basis that the amounts are considered excessive or not at arm's length. Rather, adjustments to the deduction claims on the grounds that they are excessive could be challenged only by the anti-avoidance sections, in particular, section 61A of the IRO. There appears to be a clear argument based on these comments that, under the present provisions of the IRO, the only real basis on which TP arrangements can be challenged by the IRD is via the anti-avoidance provisions of the IRO, which is different from IRD's view in DIPN 46, that the use of sections 16(1), 17(1)(b) and 17(1)(c) in the IRO is also applicable in the context of TP issues. This creates a degree of uncertainty as to whether IRO sections 16(1), 17(1)(b) and 17(1)(c) are relevant to TP matters and perhaps require a further CFA case to clarify.

Penalties
The IRO does not provide a specific penalty regime directed at a TP 'offence', nor does DIPN 46 comment specifically on penalties. Penalties may be imposed in accordance with the general penalty provisions. Taxpayers are potentially subject to penalties under section 82A in the event that TP is successfully challenged by the IRD. In the absence of a 'reasonable excuse', and when the IRD successfully challenges TP arrangements under anti-avoidance provisions, penalties may apply. In Hong Kong, the IRD can potentially apply penalties of up to 300% of underpaid tax.

Documentation
Although the IRO does not mandate preparation of TP documentation, DIPN 46 provides guidance on the type of information that is useful to maintain. Such information includes, but is not limited to, an analysis of the functions and risks undertaken by the taxpayer, and the methodology upon which it derived the transfer price.

Comparable information is generally available through various databases. No specific guidance is provided by the IRD on the sources of comparable data. We understand, however, that the IRD has subscribed to the Bureau van Dijk (BvD) Electronic Publishing SA's OSIRIS database.

Transfer pricing controversy and dispute resolution
Burden of proof
In Hong Kong, the burden of proof lies with the taxpayer. Although the IRD does not intend to impose disproportionate compliance costs on enterprises carrying on business in Hong Kong, these enterprises are required to draw up their accounts truly and fairly, and may be called upon to justify their transfer prices and the amount of profits or losses returned for tax purposes in the event of an enquiry, audit or investigation.

Tax audit procedures
Transfer pricing documentation is not mandatory under the IRO, and no specific details are provided in the IRO in relation to TP-focused audits. However, given that the statute of limitations in Hong Kong is six years from the end of the year of assessment and the view of the IRD as expressed in the DIPN 46 can be applied retrospectively, taxpayers should keep good records to support the arm's-length nature of their related-party transactions. Furthermore, to determine the accuracy of a tax return, the IRD may require any taxpayer to provide sufficient records that would allow the IRD to obtain full information in respect of the taxpayer's income. Such records are required to be maintained for a period of not less than seven years after the completion of the transactions, acts or operations to which the taxpayer has undertaken.

Resources available to the tax authorities
The IRD currently has no specific unit devoted to deal with TP investigations. However, the IRD has specific resources for its APA programme and hence is continuously building its expertise in the TP area by training its assessing staff as well as participating in technical knowledge sharing and exchange seminars with tax authorities in other jurisdictions.

Limitation of double taxation and competent-authority proceedings
There is currently no mechanism to obtain double taxation relief for TP adjustments made in a non-DTA context. In addition, the mechanism for double taxation relief in a DTA context requires agreement by the IRD on the TP adjustment made by the other side. This means that a corresponding adjustment made in a DTA context is by no means automatic.

If there is no agreement on the IRD side, taxpayers may seek to resolve the issue with the competent authority of the other side through a mutual agreement procedure (MAP). However, MAPs contain no obligation for both sides to reach an agreement on resolving the double taxation that arises from TP adjustments.

Advance pricing arrangements (APAs)
DIPN 48 was issued in March 2012, providing guidance for taxpayers to apply for APAs in Hong Kong under the DTA framework. The APA programme is open to all residents and non-residents with a permanent establishment in Hong Kong, subject to profits tax and have related-party transactions pertinent to Hong Kong. The threshold for an APA application is 80 million Hong Kong dollars (HKD) each year for sale and purchase of goods, HKD 40 million per annum for services, or HKD 20 million per annum for intangible properties. The IRD may, at its discretion, relax the eligibility criteria to allow an enterprise access to the APA process.

The Hong Kong APA process follows the five stages of (1) pre-filing, (2) formal application, (3) analysis and evaluation, (4) negotiation and agreement, and (5) drafting, execution and monitoring. In general, an APA will apply for 3–5 years. The Commissioner does not charge any fee on enterprises during the APA process on the Hong Kong side. The tentative timeframe for concluding an APA is 18 months from the acceptance of the formal application.

DIPN 48 states that the Commissioner is only prepared to consider bilateral or multilateral APA applications, at least at the initial stage of the programme, unless certain conditions for a unilateral APA apply.

Since the introduction of the APA programme in March 2012, the IRD has concluded two bilateral APAs to date (as of 1 May 2015) with the APA partners being the Netherlands and Japan. The IRD continues to welcome and encourages APA applications from taxpayers and we understand that the IRD has a healthy pipeline of APA cases which include coverage of TP arrangements with other double tax treaty partners.

Comparison with OECD Guidelines

Hong Kong is not a member of the OECD. The IRD, however, expresses its view in DIPN 46, that it would generally seek to apply the principles in the OECD Guidelines, except where they are incompatible with the express provisions of the IRO. The IRD supports the use of the arm's-length principle and has acknowledged that the changes relating to the OECD's Transfer Pricing Guidelines as a result of the BEPS project may affect Hong Kong taxpayers.

Hong Kong

45.

Hungary

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Overview

Even prior to its membership with the Organisation for Economic Co-operation and Development (OECD) in May 1996, Hungary had already introduced transfer pricing (TP) legislation in 1992. Section 18 of the Hungarian Corporate and Dividend Tax Act (CDTA) prescribes the use of the arm's-length principle (referred to as the 'customary market price') when setting the consideration associated with business contracts between affiliated companies.

On 1 January 2003, a new subsection introducing TP documentation requirements was added to section 18 of the CDTA. Currently, Decree No. 22/2009 of the Ministry of Finance ('the Decree' or 'Decree No. 22/2009') regulates the Hungarian TP documentation requirements. These regulations require taxpayers to document nearly all inter-company agreements, with respect to the method in which the arm's-length price was determined. Such documentation should be modified if there is a change in the relevant circumstances which would cause unrelated enterprises to renegotiate the pricing terms and conditions.

Country	**Hungary**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	By the time the tax return is filed
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes

Hungary

Country	Hungary
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Up to 50% of the tax shortfall

Introduction

Hungary became a member of the OECD in May 1996 and of the European Union (EU) on 1 May 2004.

Hungary as an OECD Member State has acknowledged that the arm's-length principle as defined in Article 9 of the OECD Model Tax Convention is the international TP standard to be used.

The tools at the disposal of the tax authorities to monitor compliance include notification requirements, documentation and tax audits. In addition to the incremental tax that becomes payable, the costs of non-compliance with TP rules include tax penalties of 50% of the adjustment as well as interest on late payments of tax.

Legislation and guidance

Statutory rules

On 1 January 2003, a new subsection introducing TP documentation requirements was added to section 18 of the CDTA. This provision was followed by more detailed regulations contained in Decree No. 18/2003 of the Ministry of Finance.

On 16 October 2009, Decree No. 22/2009. (X.16) of the Ministry of Finance was published containing the changes of the documentation requirements pertaining to the determination of the arm's-length price replacing the previous decree. Decree No. 22/2009 came into effect as of 1 January 2010, and is first applicable to TP documentation regarding the 2010 tax year.

These regulations require taxpayers to document each related-party agreement with respect to the method in which the Decree was determined, by the time the corporate income tax return is filed. Such documentation needs to be updated for changes in the relevant circumstances that could cause unrelated third parties to renegotiate the pricing terms and conditions.

Starting from 1 January 2015 the definition of related party – in addition to the direct or indirect majority control arising from the ownership status – include the taxpayer and other person if between them dominating influence is exercised relating to business and financial policy having regard to the equivalence of management.

The penalty for non-compliance with the TP documentation requirements is detailed in section 172 (16) Act XCII on the rules of taxation and is a default penalty of 2 million Hungarian forint (HUF) per transaction per year, which significantly increased for repeated non-compliance to up to HUF 4 million for each register (combined register) in the case of repeated offences. In the event of any repeat offence concerning the keeping of the same register, a default penalty of up to four times the penalty imposed for the first offence may be imposed upon the taxpayer. The tax authorities have explained that non-compliance includes lack of documentation, 'barely prepared'

documentation, or documentation that does not meet the requirements determined in the law and documentation prepared late. The documentation must cover each agreement, and the agreements cannot be consolidated unless the terms of supply or performance are the same under the agreements or their subject matter is closely related.

The basis of imposition of the default penalty is the subject of a continuing controversy on the issue of whether the correct interpretation of the Decree would impose the default penalty in respect of each absence of documentation of each agreement rather than per default identified in a tax audit. The tax authorities have stated that they interpret the imposition of a default fine based on the number of agreements for which documentation is not in place, counting each instance as a default.

Thin capitalisation

Under Paragraph j) in section 8 (1) of the CDTA, interest on liabilities in an amount pro rata to the portion of such liabilities that exceed three times the equity capital results in an increase to the corporate tax base.

For purposes of thin capitalisation, liability means the average daily balance of outstanding loans (with the exception of liabilities due from financial institutions) and outstanding debt securities, while equity capital means the average daily balance of subscribed capital, capital reserve, profit reserve and tied-up reserves.

Note: From 2012, interest-free loans received from related parties also have to be taken into account, if the tax base was decreased with the arm's-length interest, according to section 18 of the CDTA.

Penalties

Failure to comply with the Hungarian TP documentation regulations is subject to a penalty of up to HUF 14 million (approximately 50,000 United States dollars [USD]) as detailed above.

Adequate and timely documentation should not be underestimated as an indicator of the taxpayer's good faith if transfer prices are queried. Good faith clearly will have a bearing on the resolution of a TP dispute.

Transfer pricing adjustments (assuming they are in favour of the tax authority) could not only increase the tax liability of the taxpayer, but also result in a tax penalty of 50% on any additional tax payable, plus interest on late payment of tax at twice the base rate of the National Bank of Hungary. As of 20 April 2015, the base rate of the National Bank of Hungary was 1.95%.

In addition to the above, there is also the risk of double taxation when a 'corresponding adjustment' is not accepted in the other tax jurisdiction involved.

These risks exist for qualifying agreements in any of the years open to scrutiny by the tax authority under the Hungarian statute of limitations, which is five years.

Documentation

Content requirements for the TP documentations regarding the 2010 tax year are regulated by Decree No. 22/2009. As opposed to the provisions of the previous

decree, Decree No. 22/2009 allows the preparation of two different types of TP documentation: a country-specific, or a combined TP documentation. Taxpayers are required to declare the option they choose in their corporate tax return.

The requirements regarding the country-specific documentation mostly correspond to those set out in section 4 of Decree No. 18/2003 of the Ministry of Finance (i.e. details of the related parties and inter-company transactions, industry analysis, company and functional analysis, economic and financial analysis). According to the new decree, taxpayers are allowed to prepare a combined TP documentation that shall consist of two main parts:

- The core documentation.
- The country-specific documentation(s).

The core documentation should contain the following common standard information regarding each member company resident in any Member State of the EU:

- The general description of business structure.
- The general description of the group in terms of its organisational, legal and operational structure.
- The general denomination of the related parties conducting controlled transactions with EU group members.
- The general description of the controlled transactions, as well as the functions performed and risks assumed.
- Information on the ownership of intangible assets and on royalties paid and received.
- The description of the TP policy or system within the group.
- The cost-contribution agreements, TP resolutions and court decisions regarding the Decree.
- The date on which the documentation was prepared or amended.

The elements of the country-specific documentation are generally similar in both cases. The country-specific documentation includes: relevant data of the related parties involved in the controlled transaction; general description of the taxpayer's business enterprise and business strategy; description of agreements; benchmark analysis; and the description of comparable data.

Other regulations

Sources, adjustments, narrowing

Effective from 1 January 2015 an additional section (i.e. Section 7) was added to Decree No. 22/2009 prescribing certain adjustments and narrowing for taxpayers as follows.

When determining the arm's-length price, the taxpayer may take the following sources into account:

a. Contracts concluded with a non-related party.
b. Contracts between a related and a non-related party.
c. Contracts between non-related parties.
d. Information on comparable products and services from databases that are publicly accessible or verifiable by the tax authority, or information available from other sources that are publicly accessible or verifiable by the tax authority.

e. Information on comparable companies from databases that are publicly accessible or verifiable by the tax authority, or information available from other sources that are publicly accessible or verifiable by the tax authority.

According to Section 7/A of the Decree, in the case of applying the provisions of Section 7 points d–e, taxpayers may, at their discretion, make additional adjustments in order to improve comparability, whether or not such adjustments are specified in the guidelines referred to in Section 31 (2) point b of the CDTA (i.e. OECD TP Guidelines for Multinational Enterprises and Tax Administrations); however, taxpayers must properly document the adjustments performed, including an explanation of how the adjustments in question improve comparability.

In addition, according to Section 7/B of the Decree, taxpayers must determine the arm's-length range in accordance with Section 18 (9) of the CDTA (i.e. application of the inter-quartile range), if all of the following conditions are met:

a. The taxpayer determines the arm's-length price using any of the methods specified in Section 18 (2) points b–f of the CDTA (i.e. resale price method [RPM], cost plus method [CPM], profit split method [PSM], transactional net margin method [TNMM], other methods).
b. When determining the arm's-length price, the taxpayer takes the sources specified in Section 7 points d–e of Decree No. 22/2009 into account.
c. When preparing the country-specific or combined documentation, the benchmark analysis takes into consideration the data of at least three financial years of at least ten companies, or the comparable sample range exceeds 15 percentage points.

However, if the taxpayer has carried out a functional analysis for all companies in the sample resulting from a benchmark analysis in accordance with Section 7/B points a–b, and has clearly proved that the controlled transaction and the compared transaction are indeed comparable by properly documenting the results of the functional analysis and the examination of other factors affecting comparability as specified in the Decree, and there are no omissions that would preclude comparability, the provisions of Section 7/B do not have to be applied.

Furthermore, it is noted that the provisions set out in Section 7 of the Decree as detailed above shall first be applied for the 2015 tax year.

Simplified documentation

According to section 6 of Decree No. 22/2009, taxpayers may fulfil their documentation obligation with the preparation of a so-called simplified documentation for low-value adding services if:

- the value of the transaction included in the contract at an arm's-length price (exclusive of VAT) does not exceed HUF 150 million in the tax year under review, 5% of the service provider's annual net sales revenue, or 10% of the recipient's annual operating costs and expenses in the tax year, the latter two of which must always be examined from the perspective of the party that prepared the documentation
- the taxpayer undertakes to determine the arm's-length price using the CPM, and
- the mark-up applied falls between 3% and 10%.

The simplified documentation should contain the details of the related parties, the subject matter, date, terms and conditions of the underlying agreement, the arm's-length price (i.e. the markup between 3% and 10%), and the date when the documentation was prepared.

The services that may qualify as low-value adding services by nature are specifically listed in the Decree as follows:

- Information technology services.
- Real estate activities.
- Professional, scientific, research and technical activities.
- Education services.
- Administrative services.
- Transport, transport agency, cargo handling, warehousing and storage services.
- Other (accommodation, canteen and guard services).

Exceptions
Taxpayers are not required to provide TP documentation in a number of circumstances specified in the Decree, which include:

- To transactions made by a foreign branch of a resident taxpayer with its related party, if the resident taxpayer makes adjustments in its corporate tax base pursuant to international agreement so that it contains no income that is subject to taxation abroad.
- In connection with related-party transactions if the state tax authority has issued an advance pricing agreement (APA) resolution establishing the arm's-length prices for the period starting from the tax year in which the APA request was submitted until the last day of the tax year in which the resolution expires, provided that the facts established in the resolution remain unchanged.
- If the consideration due for goods or services supplied by a third party is recharged in full to a related party.
- In the case of liquid assets transferred without consideration.
- If the value of the transaction included in the contract at an arm's-length price (exclusive of VAT) does not exceed HUF 50 million during the tax year. When determining the threshold (irrespective of the fact of consolidation), the aggregate value of the transactions included in the contracts that may be consolidated under this Decree must be taken into consideration.

The requirement for documentation does not apply to individuals, small or micro enterprises (as defined in section 3, Act XCV of 1999), transactions conducted on the stock exchange, or at an officially set price (however, cases of insider trading, fraudulent attempts to influence exchange rates or applying prices in breach of legal regulations are not exempt).

Transfer pricing controversy and dispute resolution

Legal cases
There has been little in the way of legal cases dealing with TP in Hungary and the majority of the final decisions made by the Court are in the favour of the tax authority. Note that the number of arbitrations has increased recently.

Burden of proof

Since the introduction of TP documentation requirements, the burden of proof has passed on to the taxpayer. Taxpayers are required to support their related-party transactions with specific documentation that has to be in place on the date a corporate income tax return is filed.

As the documentation rules are clear as to the level of detail and approach required, taxpayers are faced with carrying out a detailed analysis of their related-party transactions.

In the event that adequate documentation is in place, it is up to the tax authorities to demonstrate that the method selected, the search criteria and the uncontrolled comparables identified are not applicable. This assumes that the functions are correctly determined and the financial analysis and implementation of related-party agreements are correctly disclosed.

Tax audit procedures

The number of TP audits has increased significantly in the previous years, and this trend is expected to continue in the future. During these audits, the tax authority reviews the formal elements and also the supporting analysis of the inter-company transactions from an arm's-length point of view. Standard tax audits have raised queries regarding the degree of compliance with the related-party documentation regulations, with increasing numbers of questions regarding the TP methodology selection.

Facing budgetary pressures, the Government has been under pressure to step up enforcement activities. At the same time, in recent submissions on creating a sustainable investment climate, the Government has emphasised that it will also seek to address taxpayers' concerns of transparency in the enforcement of legislation. Regarding penalties, the Hungarian tax authorities have been active in publicising that:

- penalties should not be considered to be a one-time payment as an alternative to compliance, and
- taxpayers will now be held to due dates, which previously have not been strictly enforced.

The penalties were introduced to encourage taxpayer compliance with the legislation in the belief that the penalty would never have to be imposed. Non-compliance with the legislation in practice has resulted in the recent public campaign of the tax authorities to educate taxpayers about what is to come.

Revised assessments and the appeals' procedure

Almost all Hungarian taxes are levied by self-assessment. In other words, the taxpayer must file the return and make any payment by the due date, without waiting for a formal assessment or payment demand from the tax authorities.

In Hungary, a tax authority audit can be started at any time during the five years following the end of the year in which the return was originally due. The statutory period of limitations for starting a tax audit is, therefore, six calendar years from the year-end date. The tax auditors generally make field visits to the taxpayer's premises lasting several weeks and covering a span of two to five years. Their findings are discussed with the taxpayer and its representatives.

The tax authority will issue minutes on its findings, and the taxpayer has 15 days to file their response to the minutes. The tax authority then issues its first-level resolution. Appeals against the first-level resolution have to be filed within 30 days to a higher authority within the tax administration. A second-level resolution may be issued by the tax authority following the appeal against the first-level resolution. The taxpayer can then submit appeals against the second-level resolution to the relevant court and can parallel request a supervisory measure from the head of the tax authority and the secretary of the Ministry of the National Economy.

Resources available to the tax authorities

The tax authority set up a central TP unit in 2006 to carry out TP-specific audits and assist in local general tax audits when a TP issue is identified. This unit also works closely with the department of large taxpayers, which looks after the largest taxpayers in Hungary. As of 1 January 2007, the tax authority's directorate of high importance taxpayers has sole jurisdiction in cases defined by law, as well as in cases involving taxpayers regarded as 'high importance' under separate legislation. It is also responsible for conducting centralised inspections.

According to the Decree No. 4/2012 (II.14.) of the Ministry of National Economics, high-importance taxpayers include credit institutions and insurance companies organised as joint stock companies and taxpayers (except for state entities, sole proprietors and private persons defined by the Personal Income Tax Act) with tax obligations (i.e. all tax obligations of a company including those collected and payable by the company) of HUF 2,400 million or more, provided that they started their operation two years or more before the tax year and that they are not subject to bankruptcy, liquidation, or winding-up proceedings on the last day of the year preceding the tax year.

Use and availability of comparable information

The tax authority has introduced a number of external databases, which it uses to assist in its tax audits. The two major publicly available Hungarian databases are KJK-Kerszöv DVD Céghírek and IM Online, where public financial information can be downloaded on Hungarian companies. The tax authority also uses Bureau van Dijk's AMADEUS database and Bloomberg databases, and has developed its own internal database on the basis of the financial information received during tax audits.

Risk transactions or industries

The tax authority has publicly stated that it considers entities that are either loss-making or show an accounting profit of less than 2% of gross revenue as the subject of particular attention in TP audits.

Advance pricing agreements (APAs)

Hungary adopted legislation regarding APAs on 1 January 2007. The Decree No. 38/2006 of the Ministry of Finance details the procedure for making applications for APAs. An application form is available at the Hungarian tax authority website (http://www.nav.gov.hu).

Procedure

The applications for APAs are lodged with the tax authority's Directorate of High Importance Taxpayers and are required to be co-signed by a tax adviser, a tax expert (a registered professional tax specialist in Hungary), a chartered tax consultant or a lawyer.

Fees
The fees are 1% of the arm's-length price determined by the authority with the following limits:

- HUF 500,000 but no more than HUF 5 million for a unilateral APA where traditional methods (comparable uncontrolled price method [CUP Method], RPM, and CPM) are applied.
- HUF 2 million but no more than HUF 7 million for unilateral APA where profit-based methods (TNMM and PSM) are applied.
- HUF 3 million for a bilateral APA, but no more than HUF 8 million.
- HUF 5 million for a multilateral APA, but no more than HUF 10 million.

The application should be accompanied by a copy of the receipt certifying payment of the application fee in full, duly signed by the issuing bank.

If an application for an APA is dismissed, the tax authority will refund 75% of the application fee to the taxpayer within 15 days of the resolution on the dismissal of the application (usually 30 days after the issue of a resolution).

The application may be requested for three to five years and may be extended (once for three years maximum) or amended for an additional fee of 50% of the fee paid for the original proceeding.

The administrative time limit for these proceedings is 120 days, which may be extended on two occasions by 60 days.

Note: There is an Annex to Decree No. 38/2006 of the Minister of Finance that sets out the details to be included in the APA application.

Notification to the local tax office
All applications for an APA are automatically notified to the local tax office dealing with the day-to-day tax affairs of the taxpayer.

Appeals
Appeals against the first instance resolution (ruling) must be addressed to the chairman of the tax authority and filed with the tax authority's Central Office. If, following an unsuccessful appeal, the resolution (ruling) is not cancelled, amended, corrected, replaced or complemented as requested in the appeal, the decision on the appeal must be prepared and presented to the chairman by a tax authority unit, organisationally independent and separate from the unit that prepared the first instance resolution. This provides some comfort that there will at least be a peer review of unsuccessful appeals.

Bilateral and multilateral procedures
In bilateral and multilateral procedures, the taxpayer will not be involved in the exchange of information or multilateral procedure between the Hungarian tax authority and the foreign tax authority or authorities. The Hungarian tax authority does, however, have the right to request the applicant to supply, within eight days, any additional information at the applicant's disposal, which is considered material for the purposes of assessing the APA application, or for clarifying new facts, data or circumstances, if any, that may emerge in the course of such procedures.

Advance pricing arrangement in practice
The tax authority requires information requested in the Decree to be supplied in advance of the submission of the application for APAs and it is usual for a preliminary meeting to be held with the tax authorities to explain the background of the application and clarify any initial queries that the tax authority may have in respect of the information provided. The Hungarian tax authorities are, in practice, generally helpful in ensuring a smooth APA procedure for the taxpayer.

Comparison with OECD Guidelines

OECD issues
The Decree No 22/2009 of the Minister of Finance on Documentation states that it is based on the OECD TP Guidelines for Multinational Enterprises and Tax Administrations and related protocols, which include the OECD TP Documentation Guidelines. Therefore, the OECD TP developments should be seen to play a major part in the development of TP legislation and practice in Hungary.

Anticipated developments in law and practice
The Hungarian TP legislation continues to develop as part of the general harmonisation with EU legislation and directives and therefore taxpayers can anticipate significant developments in the future, both in terms of the quality of the tax audits and legislative background. The last year has already seen an increase in the quality of tax audits and imposition of default penalties where documentation is either incomplete or not available. This is expected to be a continuing trend.

46.
Iceland

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Overview

Special provisions on pricing and/or terms of related-party transactions were implemented in Iceland on 1 January 2014. These provisions are meant to supplement the arm's-length principle that the tax authorities in Iceland have so far relied on in deciding the tax base in trade between related parties.

The Income Tax Act includes several other separate rules that can be identified as transfer pricing (TP) rules. However, those rules generally concern transactions between individuals rather than between companies (e.g. a rule that obligates employees who receive their wages in kind to account for them on their tax return based on market value).

The VAT Act also includes separate rules that can be identified as TP rules, as they address issues concerning how to price products when transactions between related parties occur.

Several legal cases concerning TP have reached the State Internal Revenue Board. A few cases have also reached the district courts and the Supreme Court of Iceland. No TP cases are currently being processed through the courts.

In some legal cases of a different nature, it has been established that TP issues can be addressed on the grounds of Article 57 of the Income Tax Act, even though the rule is considered a general anti-avoidance clause. These cases also established the arm's-length principle for transactions between related parties.

There is no case law yet on the newly implanted TP provisions in the Income Tax Act noted above.

Iceland

Country	Iceland
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP Documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Each year
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	15%–25% on top of the adjustment

Introduction

On 1 January 2014, a new TP regime was introduced in Iceland. Previously, Iceland had no direct TP legislation, but it was a member of the Organisation for Economic Co-operation and Development (OECD) and subscribed to the principles contained in the OECD Guidelines. However, there were no direct references in Icelandic tax law or in other legislation to the OECD Guidelines.

Regulations to provide additional guidance on documentation are currently being drafted by the Ministry of Finance.

Legislation and guidance

In Article 57, Paragraph 3 of the Income Tax Act no. 90/2003, it is now stated that if pricing and/or terms of trade between related legal entities is not comparable to general terms of trade in a transaction between unrelated parties, the tax authorities shall evaluate and, as appropriate, adjust the tax base as to whether the terms of the trade prove to be over- or undervalued. In the provision it is specifically stated that when doing this, the tax authorities shall follow the OECD Guidelines on TP. The term 'trade' as it is applied in Article 57 refers to the general purchase and sale of goods and services, tangible and intangible assets, and any financial instruments.

According to these provisions, legal persons are considered to be related when:

- they are part of a group of companies, as a group is defined in Article 2 of law no. 3/2006, on financial statements, i.e. when one company holds the majority of shares in another company, or has the ability to nominate or dismiss the majority of the board or management of a company, or has the power to authoritatively decide matters concerning the business or financial matters of a company according to the articles of association of a company or a contract signed with a company, or controls the majority vote in a company due to an agreement with the shareholders, or holds shares in a company and has the power to authoritatively decide matters concerning the business or financial matters of this company, or

- they are under direct or indirect majority ownership or management control of two or more legal entities within a group of companies, or
- when the majority ownership over a another legal entity is present in a combined way, either directly or indirectly, or
- they are directly or indirectly majority owned or under the administrative control of individuals who are connected by family ties, e.g. married individuals or individuals in a registered partnership, siblings and persons related to each other in a direct line. The same applies to individuals involved in financial ties through joint trade and investment.

Penalties
Penalties in the range of 15%–25% on top of the tax base are applied where an adjustment is performed, based on a TP tax audit or a general tax audit.

Documentation
Legal entities that have operating revenues of over one billion Icelandic króna (ISK) in a single fiscal year or have assets estimated at over ISK one billion at the beginning or at the end of the fiscal year, are required to record and file information about the nature and extent of transactions with related legal entities, the nature of the relationship between the entities and the basis of the decision of price in transactions between the entities. Those entities that are obliged to document their transactions with related entities shall preserve data on such transactions and information about the terms of the trade, turnover, assets and anything that can affect the pricing and terms of the transaction. They shall also be able to demonstrate the value and terms of similar transactions between unrelated parties and how pricing is carried out with respect to the OECD Guidelines on TP. A legal entity that is obliged to document its transactions with related entities shall verify that documentation obligation has been fulfilled upon filing its tax return.

Transfer pricing controversy and dispute resolution
The tax authorities carry the full burden of proof when trying to establish that a TP adjustment is needed.

Tax audit procedures can be based on predetermined tax audit programmes, or on a random inspection of tax returns. The tax authorities can request any information on the taxpayer and the taxpayer must cooperate with the tax authorities on all tax audit procedures. The tax audit is performed by local tax offices of the Directorate of Internal Revenue located around the country.

Tax audits can be performed only within the domestic statute of limitation period (i.e. six years). If an investigation by the Directorate of Tax Investigations has started, then the six years' statute of limitation period starts from the beginning of the year the investigation started.

The taxpayer has the right to an appeal to the local tax office of the Director of Internal Revenue. This appeal must be set forth within 30 days from the decision date. If the taxpayer does not meet that deadline, then they can file a formal complaint with the Directorate of Internal Revenue. Tax authorities have two months to process the complaint. When a decision has been made, the taxpayer can appeal to the State Internal Revenue Board within three months, or take the case to the district courts.

Comparison with OECD Guidelines

Iceland is a member country of the OECD and has embraced the OECD Guidelines for TP purposes. As noted above, there is a reference to the OECD Guidelines in the newly implemented provisions on TP, where it is stated that when adjusting the tax base in TP cases, the tax authorities shall follow the OECD Guidelines on TP.

47.
India

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Overview

The Indian regulations are now over a decade old, and transfer pricing (TP) continues to be a focus area for the Indian tax authorities. In the past couple of years, there have been many modifications in the Indian TP legislation. The major changes include introduction of domestic TP regulations, providing additional explanations to the definition of international transactions, introduction of an advance pricing agreement (APA) programme and publishing safe harbour rules.

Probably the two most significant new measures are the introduction of APAs and safe harbours, both of which provide taxpayers with opportunities to achieve certainty on TP matters. The Indian APA programme was introduced in 2012, which has received an overwhelming response from the taxpayers. Over 550 unilateral and bilateral APAs have been filed, and within 3 years of introduction, nine APAs have been concluded (eight unilateral APAs and one bilateral APA), and more are expected to get concluded in the immediate future. To make the APA programme more robust, the Indian Union Budget 2014 introduced rollback provisions in the APA regulations in line with global standards. The option of rollback is of great relief to the taxpayers as the negotiations under the APA can be adopted for prior years, which may reduce the litigation burden. Recently, the Indian Government notified rollback rules allowing the taxpayer to opt for rollback of APA up to four financial years, beginning with the previous year immediately before the period for which the APA is entered into. Post the rollback provisions, a taxpayer can now achieve tax certainty for up to nine years though the APA mechanism.

Another major legislative change in the recent past has been the notification of safe harbour rules for the first time in financial years (FY) 2012–13. The prescribed rules have notified various international transactions for which an eligible taxpayer can seek a safe harbour. These include provision of IT/IT enabled services, outbound guarantees and loans, etc. However, considering that the prescribed safe harbours are on the higher side, the number of companies adopting the safe harbour route has been insignificant.

India

The recent Union Budget, 2014 also introduced certain changes in the TP rules with an aim to align the Indian TP regime with the global accepted practice. The new rules provide for the use of a 'range' of comparable data to determine the arm's-length price, instead of relying on the mean (average) except for cases where range cannot be determined. In addition, there was ongoing TP litigation on the restricted use of multiple year data and the tax authorities' insistence on use of data of the single year to which the transactions pertain. This has routinely led to the authorities using single year data at the time of TP audits. In a move to reduce the litigation on TP issues, Union Budget, 2014 has introduced use of multiple year data of comparable companies. Once the rules regarding these changes are framed, the above proposals are likely to reduce TP litigation and usher in more certainty for taxpayers in India.

In terms of TP disputes, there are various other issues such as excessive expenditure on advertisement and marketing activities, payment of royalty and management fees, payment of interests on borrowings from overseas affiliates, provision of corporate guarantee towards borrowings by overseas affiliates, and receivables due from overseas affiliates beyond a reasonable time frame, are the most scrutinised transactions. With the introduction of APA, augmented with the changes made in the Union Budget 2014, it is expected that TP litigation will reduce and taxpayers can achieve greater certainty.

Country	**India**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	On or before filing of tax return (30 November)
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes (separate form prescribed)
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the value of international transaction and a fixed amount in certain cases.

Introduction

A separate code on TP under sections 92 to 92F of the Indian Income Tax Act 1961 (the Act) covers intragroup cross-border transactions, which is applicable from 1 April 2001 and specified domestic transactions, which is applicable from 1 April 2012. Since the introduction of the Code, TP has become the most important international tax issue affecting multinational enterprises (MNEs) operating in India. The regulations

are broadly based on the Organisation for Economic Co-operation and Development (OECD) Guidelines and describe the various TP methods, impose extensive annual TP documentation requirements and contain penal provisions for non-compliance.

Legislation and guidance

The Indian TP Code prescribes that income arising from international transactions or specified domestic transactions between associated enterprises should be computed having regard to the arm's-length price. It has been clarified that any allowance for an expenditure or interest or allocation of any cost or expense arising from an international transaction or specified domestic transaction also shall be determined having regard to the arm's-length price. The Act defines the terms 'international transactions', 'specified domestic transactions', 'associated enterprises' and 'arm's-length price'.

Type of transactions covered

Section 92B of the Act defines the term 'international transaction' to mean a transaction between two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property; provision of services; cost-sharing arrangements; lending/borrowing of money; or any other transaction having a bearing on the profits, income, losses or assets of such enterprises. The associated enterprises could be either two non-residents or a resident and a non-resident; in addition, a permanent establishment (PE) of a foreign enterprise also qualifies as an associated enterprise. Accordingly, transactions between a foreign enterprise and its Indian PE are within the ambit of the Code.

An explanation having an inclusive list of transactions has been inserted in the definition of 'international transaction' by the Finance Act 2012, to specifically cover certain transactions/arrangements like purchase, sale, transfer, lease or use of intangible property, provision of guarantees, deferred payments or receivables, business restructuring or reorganisation, etc. Intangible property has been explained to include marketing intangible, customer-related intangible, human capital intangible, location-related intangible, etc. These clarifications have been inserted retrospectively with effect from 1 April 2001.

Until FY 2011–12, TP regulations were not applicable to domestic transactions. However, the Finance Act 2012 has extended the application of TP regulations to 'specified domestic transactions', being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds 50 million Indian rupees (INR). The Finance Act 2015 revised the threshold limit for application of TP regulations to specified domestic transactions from INR 50 million to INR 200 million. The aforesaid revised threshold limit is applicable from FY 2015-16 onwards.

- Any expenditure with respect to which deduction is claimed while computing profits and gains of business or profession.
- Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (section 80-IA) and SEZ (Special Economic Zones) units (section 10AA).
- Any other transactions as may be specified.

This amendment is applicable from FY 2012–13.

Associated enterprises
The relationship of associated enterprises (AEs) is defined by section 92A of the Act to cover direct/indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations in which the same person (directly or indirectly) participates in the management, control or capital of both the enterprises.

For the purposes of the above definition, certain specific parameters have been laid down, based on which, two enterprises would be deemed as AEs. These parameters include:

- Direct/indirect holding of 26% or more voting power in an enterprise by the other enterprise, or in both the enterprises by the same person.
- Advancement of a loan, by an enterprise, which constitutes 51% or more of the total book value of the assets of the borrowing enterprise.
- Guarantee by an enterprise for 10% or more of total borrowings of the other enterprise.
- Appointment by an enterprise of more than 50% of the board of directors, or one or more executive directors of the other enterprise, or the appointment of specified directorships of both enterprises by the same person.
- Complete dependence of an enterprise (in carrying on its business) on the intellectual property licensed to it by the other enterprise.
- Substantial purchase of raw material/sale of manufactured goods by an enterprise from/to the other enterprise at prices and conditions influenced by the latter.
- The existence of any prescribed relationship of mutual interest.

Besides, in certain cases, a transaction between an enterprise and a third party might be deemed to be a transaction between AEs if there exists a prior agreement in relation to such transaction between the third party and an AE, or if the terms of such transaction are determined in substance between the third party and an AE. Accordingly, this rule aims to counter any move by taxpayers to avoid the TP regulations by interposing third parties between group entities. This provision could be triggered irrespective of whether the third party is a tax resident in India, or not.

Also, as per section 94A of the Act, if a taxpayer enters into a transaction in which one party is a person located in a notified jurisdictional area (NJA), then all the parties to the transaction shall be deemed to be AEs and any transaction with such party shall be deemed to be an international transaction. This regulation aims to specify countries or territories outside India having lack of effective exchange of information as NJAs. Presently, only Cyprus has been notified as an NJA under section 94A.

Arm's-length principles and pricing methodologies
The term 'arm's-length price' is defined by section 92F of the Act to mean a price that is applied or is proposed to be applied to transactions between persons other than AEs in uncontrolled conditions. The following methods have been prescribed by section 92C of the Act for the determination of the arm's-length price:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).
- Such other method as may be prescribed.

In this regard, the Central Board of Direct Taxes (CBDT) has notified that the 'other method' for determination of the arm's-length price in relation to an international transaction shall be any method which takes into account the price that has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. The 'other method' is applicable from FY 2011–12 onwards.

No particular method has been accorded a greater or lesser priority. The most appropriate method for a particular transaction would need to be determined, having regard to the nature of the transaction, class of transaction or associated persons and functions performed by such persons, as well as other relevant factors.

The regulations need a taxpayer to determine an arm's-length price for international transactions or specified domestic transactions. It further provides that where more than one arm's-length price is determined by applying the most appropriate TP method, the range of such prices shall be the arm's-length price of the international transaction or specified domestic transactions. The exact definition of this range is yet to be notified. In addition, TP provisions will not apply if the arm's-length price would result in a downward revision in the income chargeable to tax in India.

Safe harbour rules

With a view to reduce the number of TP audits and prolonged disputes in matters relating to comparability analysis under TP, the CBDT was empowered to formulate safe harbour rules in April 2009. The CBDT notified the rules governing safe harbours in India in September 2013, specifying the circumstances in which the tax authorities will accept the arm's-length price as declared by a taxpayer, without detailed analysis subject to the fulfilment of certain criteria. The safe harbour rules have defined an 'eligible assessee' and thereafter different thresholds have been prescribed for specific activities/transactions, such as software development services, information technology-enabled services, knowledge process outsourcing services, contract research and development services in software development and generic pharmaceuticals, contract manufacturing of core and non-core auto components and transactions, relating to interest payments on loans and guarantees provided to AEs. Further, the CBDT also notified safe harbour rules for specified domestic transaction in case of government electricity companies. However, considering that the notified safe harbour mark-ups/prices are on the higher side, the response to the safe harbour rules has been limited with very few companies adopting this mechanism.

Thin capitalisation

The arm's-length principle applies to loans and interest charges. But, at present, there are no rules that specifically deal with thin capitalisation and do not set permissible debt-to-equity ratios in the Act or the TP Code. However, the Indian government intends to introduce general anti-avoidance rules (GAAR) in the next 2 years which incorporate the provision of thin capitalisation.

The proposed regulations do not prescribe any capital gearing ratio unlike typical thin capitalisation regulations, but instead provide for recharacterisation of debt as equity and vice versa on identification of an impermissible avoidance arrangement – in other words, where the arrangement among parties is i) not at arm's length, ii) lacks commercial substance, or iii) adopts means that are ordinarily not adopted for bona fide purposes. The absence of a specified capital gearing ratio allows subjectivity

and discretion at the hands of the Revenue while it evaluates whether a given capital structure is an impermissible avoidance arrangement.

The proposed thin capitalisation provisions are now becoming an area of concern – it is so desirable that MNEs operating in India should look at their respective capital structures in light of appropriate and acceptable benchmarks.

Penalties

The following stringent penalties have been prescribed for non-compliance with the provisions of the TP Code:

- For failure to maintain the prescribed information/document: 2% of transaction value.
- For failure to furnish information/documents during audit: 2% of transaction value.
- For failure to disclose any transaction in accountant's report: 2% of transaction value.
- For adjustment to taxpayer's income: 100% to 300% of the total tax on the adjustment amount.
- For failure to furnish an accountant's report: INR 100,000.

Further, taxable income enhanced as a result of TP adjustments cannot get various tax concessions/holidays prescribed by the Act.

Documentation

Taxpayers are required to maintain – on an annual basis – a set of extensive information and documents relating to international transactions undertaken with AEs or specified domestic transactions. Rule 10D of the Income Tax Rules 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer. Such requirements can broadly be divided into two parts.

The first part of the Rule lists mandatory documents/information that a taxpayer must maintain. The extensive list under this part includes information on ownership structure of the taxpayer, group profile, business overview of the taxpayer and AEs, prescribed details (nature, terms, quantity, value, etc.) of international transactions or specified domestic transactions and relevant financial forecasts/estimates of the taxpayer. The Rule also needs the taxpayer to document a comprehensive TP study. The requirement in this respect includes documentation of functions performed, risks assumed, assets employed, details (nature, terms and conditions) of relevant uncontrolled transactions, comparability analysis, benchmarking studies, assumptions, policies, details of adjustments and explanations as to the selection of the most appropriate TP method.

The second part of the Rule needs adequate documentation to be maintained, which substantiates the information/analysis/studies documented under the first part of the Rule. The second part also contains a recommended list of such supporting documents including government publications, reports, studies, technical publications/market research studies undertaken by reputable institutions, price publications, relevant agreements, and contracts and correspondence.

Taxpayers having aggregate international transactions below the prescribed threshold of INR 10 million and specified domestic transactions below the threshold of INR 50 million (revised to 200 million *vide* Finance Act 2015) are relieved from maintaining the prescribed documentation. However, even in these cases, it is imperative that the documentation maintained should be adequate to substantiate the arm's-length price of the international transactions or specified domestic transactions.

All prescribed documents and information have to be contemporaneously maintained (to the extent possible) and must be in place by the due date of the tax return filing. Companies to which TP regulations are applicable are currently required to file their tax returns on or before 30 November following the close of the relevant tax year. The prescribed documents must be maintained for a period of nine years from the end of the relevant tax year, and must be updated annually on an ongoing basis.

Use and availability of comparables' information

Taxpayers are required to maintain information on comparables as part of their TP documentation to demonstrate that the pricing policy complies with the arm's-length principle. Comparable information is a crucial element for defending TP in India. Indian Revenue officials have indicated that, to the extent possible, Indian comparables should be used. Use of foreign comparables is generally not acceptable, unless the tested party is located overseas. In some cases, Indian tax authorities have exercised their power to obtain private information from other taxpayers and used it against the taxpayer undergoing an audit.

The quality of comparable information available in Indian databases is reasonable. The tax authorities use a couple of electronic databases giving detailed financial and descriptive information for companies. Taxpayers also usually rely on these databases. It is also possible to obtain information about Indian public companies from the Registrar of Companies on payment of statutory fees.

Accountants' report

It is mandatory for all taxpayers, without exception, to obtain an independent accountant's report in respect of all international transactions between AEs or specified domestic transactions. The report has to be furnished by the due date of the tax return filing (i.e. on or before 30 November). The form of the report has been prescribed. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. In addition, the accountant is required to certify the correctness of an extensive list of prescribed information. The form of the report has been revised with effect from FY 2012–13 and the new format has been expanded to include various other international transactions like corporate guarantees, issue of shares, deemed international transaction, business restructuring, etc. which were not included in the earlier version.

Certain case law rulings have held that the provisions relating to the determination of the arm's-length price are machinery provisions, which would not apply in the absence of liability to pay tax and, accordingly, a taxpayer would not be required to comply with the TP regulations when the income is not chargeable to tax in India.

Indian TP Regulations provide that entities enjoying a tax holiday in India still need to comply with TP provisions and would need to demonstrate that their international transactions have been carried out at arm's length. In addition, such entities would not

be entitled to a tax holiday on any upward adjustment made to their transfer prices in the course of an audit.

Transfer pricing controversy and dispute resolution

Tax audit procedure

A certain percentage of tax returns are selected for detailed audit. A notice to this effect has to be statutorily dispatched to the taxpayer within six months from the end of the FY in which the return is furnished. Such notice specifies the records, documents and details that are required to be produced before the tax officer.

Once an audit is initiated, the corporate tax assessing officer (AO) may refer the case to a specialist TP officer (TPO) for the purpose of computing the arm's-length price of the international transactions or specified domestic transactions. Such reference may be made by the AO wherever they consider it necessary. However, this can be done only with the prior approval of the Commissioner of Income Tax.

According to prevailing internal administrative guidelines of the Revenue, all taxpayers having an aggregate value of international transactions or specified domestic transactions with AEs more than INR 150 million are referred to a TPO for detailed investigation of their transfer prices. The threshold of INR 150 million might be reviewed on an ongoing basis.

The TPO would then send a notice to the taxpayer requiring the production of necessary evidence to support the computation of the arm's-length price of the international transactions or specified domestic transactions. The prescribed documentation/information maintained by the taxpayer in respect of its TP arrangements would have to be produced before the tax authorities, during the course of audit proceedings, within 30 days after such request has been made. The period of 30 days may be extended to 60 days at most at the discretion of the TPO.

The TPO would scrutinise the case in detail, taking into account all relevant factors like appropriateness of the TP method applied and correctness of data. TPOs are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath and compelling the production of books of account and other relevant documents and information. Further, with effect from 1 June 2011, TPOs have been empowered to conduct surveys for spot inquiries and verification for subsequent investigation and collation of data. In addition, TPOs have been instructed to seek opinions of technical experts in the relevant field to enable them to analyse technical evidence in complex cases.

After taking into account all relevant material, the TPO would pass an order determining the arm's-length prices of the taxpayer's international transactions or specified domestic transactions. A copy of the order would be sent to the AO and the taxpayer. On receipt of the TPO's order, the AO would compute the total income of the taxpayer by applying the arm's-length prices determined by the TPO and pass a draft order within the time limit prescribed for completion of scrutiny assessments.

Normally, scrutiny assessments are required to be completed within an upper time limit of 36 months from the end of the relevant tax year. However, scrutiny assessments involving TP audits would have to be completed within 48 months from the end of the relevant tax year. India completed its tenth round of TP audits in January 2015.

Risk transactions or industries
No transactions or industries are excluded from the possibility of a TP investigation. Software development, business process outsourcing, banking, telecommunications, pharmaceutical, fast-moving consumer goods (FMCG) and automobile (and ancillary) are some of the industries that have been subject to intense TP audits in recent times.

Outsourcing companies rendering core/high-value services to AEs need to carefully analyse and set their transfer prices. In addition, specific situations like sustained losses, business strategies, business restructurings, transactions with entities in tax havens, and royalties and management charges paid should be sufficiently documented.

Burden of proof
The burden of proving the arm's-length nature of a transaction primarily lies with the taxpayer. If the tax authorities, during audit proceedings on the basis of material, information or documents in their possession, are of the opinion that the arm's-length price was not applied to the transaction or that the taxpayer did not maintain/produce adequate and correct documents/information/data, the total taxable income of the taxpayer might be recomputed after a hearing opportunity is granted to the taxpayer.

Appeals' procedure
A taxpayer who is aggrieved by an order passed by the AO may appeal to the Commissioner of Income Tax (Appeals) being the Appellate Commissioner, within 30 days of the date of receipt of the scrutiny assessment order. The office of the Appellate Commissioner is a type of quasi-judicial authority, where the taxpayers make representations in support of their claims to rebut the order passed by the AO. The decision of the Appellate Commissioner is reflected in an appellate order.

A different dispute resolution mechanism has been instituted by the Finance Act 2009 to facilitate expeditious resolution of disputes in all cases involving TP and foreign company taxation. It has introduced the concept of draft assessment orders, which would be issued by the AO, pertaining to the order of the TPO, which is prejudicial to the taxpayer. In cases involving foreign companies or companies suffering TP adjustments, the AO is required to send the draft assessment order to the taxpayer, which would ordinarily include the order of the TPO. A dispute resolution panel (DRP), comprising a collegium of three commissioners of income tax, is constituted to which the taxpayer would have recourse on receiving the draft assessment order from the AO.

At this stage, the taxpayer has two choices: They could either accept the draft order as it is, or seek to refer the matter to the DRP. The taxpayer has to communicate its decision to the AO within 30 days of the receipt of the draft order. If the order is accepted by the taxpayer as it is, the draft would be finalised by the AO and served to the taxpayer. If the matter is referred to the DRP, the panel would have nine months from the time of referral to decide the matter, taking into consideration the draft order of the AO, the order of the TPO and the taxpayer's objections and evidence. The draft assessment order would be finalised after the DRP has rendered its decision to the AO. If the taxpayer does not communicate its decision to refer the draft order to the DRP within 30 days, the AO would finalise the assessment order without modification of the draft assessment order.

One of the major advantages of appealing before the DRP is that the taxpayer is not required to pay the tax demand until such time that the order becomes final. Therefore, there will be no immediate cash outflow for the taxpayer, while in case of an appeal to the Commissioner of Income Tax (Appeals), the taxpayer may be required to pay the tax demand (unless the collection of the tax demand has been stayed by the tax authorities). Further, the proceedings before the Commissioner of Income Tax (Appeals) tend to take a longer time for adjudication, as against a fixed time limit of nine months in the case of the DRP.

An order of the AO that is based on the direction of the DRP is appealable directly to the Income Tax Appellate Tribunal (Appellate Tribunal). All orders passed by the AO before 30 June 2012, pursuant to the directions of the DRP, were binding on Revenue. However, with respect to objections filed on or after 1 July 2012, the Revenue can appeal against the direction passed by the DRP. It is also clarified that the taxpayer would have to decide whether to opt for the dispute resolution mechanism based on the draft assessment order or file an appeal in the normal course with the Appellate Commissioner against the assessment order. As a result, the order of the AO can be agitated before the Appellate Commissioner in the ordinary course (i.e. if it is not referred to the DRP).

Taxpayers that still feel aggrieved by the order of the Appellate Commissioner or, as the case might be, the order of the AO passed in conformity with the directions of the DRP, have the right to appeal to the Appellate Tribunal, thereafter to the jurisdictional High Court, and finally to the Supreme Court. A similar right to appeal also rests with the Revenue, in cases where objections before the DRP have been filed on, or after, 1 July 2012. The appeals to High Court and Supreme Court are maintainable only on substantial questions of law.

Advance pricing agreements (APAs)

The Indian authorities have introduced unilateral, bilateral and multilateral APAs with effect from 1 July 2012. There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible for applying for an APA. However, the APA mechanism is not available for specified domestic transactions. The validity of an APA (once entered into) shall not exceed five consecutive years and shall be binding on the taxpayer as well as the Revenue authorities in respect of the international transactions for which the APA is sought, subject to fulfillment of the critical assumptions agreed to. APA fees would range between INR 1 million to 2 million, based on the value of international transactions for which the APA is being negotiated. There are four phases in an APA which is in line with global practice, as follows:

- Pre-filing phase: The process of an APA would start with a pre-filing consultation meeting. This meeting will be held to determine the scope of the agreement, understand the TP issues involved and to determine the suitability of the international transaction for the agreement. No fee is to be paid in this phase.
- Formal submission phase: After the pre-filing meeting, if the taxpayer is desirous of applying for an APA, an application in the prescribed format would be required to be made containing specified information. The APA filing fee is payable at this stage. In the application, the taxpayer must describe critical assumptions. Critical assumptions refer to a set of taxpayer-related facts and macroeconomic criteria (like industry, business, economic conditions, etc.), the continued existence of which are material to support the position concluded under an APA. A material change in any of the critical assumptions might result in revision of the APA or even termination in extreme circumstances.

- Negotiation phase: Once the application is accepted, the APA team shall hold meetings with the applicant and undertake necessary inquiries relating to the case. Post the discussion and inquiries, the APA team shall prepare a draft report, which shall be provided to the competent authority in India (for unilateral/multilateral APA) or the Director General of Income Tax (International Tax and TP) (for Unilateral APA).
- Finalisation phase: This phase involves exchange of comments on draft APA, finalisation of the APA, and giving effect to the initial years covered under the APA term that have already elapsed.

The taxpayer will be required, as part of the APA, to prepare an annual compliance report (ACR) for each year of the APA, containing sufficient information to detail the actual result for the year and to demonstrate compliance with the terms including the critical assumptions of the APA. The ACR shall be furnished within 30 days of the due date of filing the income tax return for that year, or within 90 days of entering into an agreement, whichever is later.

There has been an overwhelming response to the APA programme till 31 March 2015. Almost 550 applications have been filed, the majority being unilateral, in the last three years. As of 31 March 2015, the taxpayer and Government have negotiated and signed eight unilateral APAs and one bilateral APA while many are in the advanced stages of discussion.

Limitation of double taxation and competent authority proceedings
The competent authority provisions/mutual agreement procedure (MAP) is an alternate dispute resolution mechanism that companies are increasingly beginning to use, especially in cases where the tax amount in dispute is significant. MAP settlements typically have been sought on issues relating to TP, PE matters and profit attribution.

Most Indian tax treaties contain an AE article, which contains relieving provisions that require one country to reduce the amount of tax charged to offset the enhanced tax liability imposed by the other country to reflect the arm's-length standard. This article refers to competent authority provisions (contained in the relevant MAP article of the treaty) for consultation between authorities of both countries to prevent double taxation on taxpayers. MAP/competent authority provisions are an integral part of India's extensive treaty network.

The MAP route can be pursued by taxpayers simultaneously with the domestic dispute resolution process. In the event the MAP route is invoked, the competent tax authorities of the countries involved negotiate until they reach an agreement on the transfer prices acceptable to both authorities. To facilitate the MAP, the Indian Government has introduced rules and also has entered into a memorandum of understanding (MoU) with the competent authorities of the United Kingdom and the United States. An advantage of applying for the MAP under the MoUs mentioned is that Revenue will suspend the collection of tax, where the taxpayer has an adjustment in relation to transactions with the associated enterprises. Under the MoUs, the collection of tax is deferred while the MAP is in process. But taxpayers need to provide appropriate bank guarantees in support of the potential tax payable before resorting to the MAP.

The increasing use of MAPs by taxpayers in seeking effective resolution of TP disputes is an encouraging step in the Indian scenario.

It may be noted that in case of tax treaties entered into by India wherein Article 9(2) dealing with corresponding adjustment is absent, the office of the Indian Competent Authority has taken a position that a bilateral APA or a MAP settlement for an existing TP dispute cannot be sought by the taxpayer.

Resources available to the tax authorities

A special TP team within the Indian tax authorities deals with TP issues. The team comprises of trained TPOs who deal with TP issues arising during an audit. Indian tax authorities are actively training their staff to increase competency in handling TP issues.

Liaison with customs' authorities

The Indian Ministry of Finance had constituted a joint working group, comprising officers from Income Tax and Customs, to suggest measures for cooperation between the Income Tax and Customs departments. Based on the recommendations of the working group, the Ministry of Finance has laid down that periodic meetings should be held between Income Tax and Customs personnel to discuss joint issues requiring attention.

The Ministry of Finance also has decided that exchange of information in specific cases would be done, and for this purpose, officers from the two departments would be nominated at each of the four metros. In addition, officers from the two departments would make databases available to one another, relating to related parties/AEs on a need-to-know basis. The Ministry of Finance also has decided to develop and organise training programmes to train the officials of both departments to familiarise them with the treatment of TP matters in the other department.

The above action by the Ministry of Finance can be seen as the first clear statement of intent of the Government of India towards addressing TP matters in a harmonious manner between the Customs and Income Tax departments (as TP officers have, in the past, expressed a view that the price accepted by other authorities is not conclusive evidence for determining the arm's-length price for TP purposes). This also suggests that in the future, the Customs and Income Tax authorities could coordinate and exchange information with one another on TP matters. Such an increase in liaison between the two departments makes it imperative for companies operating in India to plan and document their transfer prices comprehensively, based on valuation principles contained in Custom as well as Income Tax laws, and also deal with both authorities in a harmonious and seamless manner.

Joint investigations

There is no evidence of joint investigations having taken place in India. However, almost all Indian tax treaties contain provisions for the exchange of information and administrative help, under which the Indian tax authorities might exchange information with other countries for TP purposes. Furthermore, with TP awareness increasing and India signing agreements/renegotiating double tax avoidance agreements with various countries for exchange of information, joint investigations might be undertaken by the Indian tax authorities in the future.

Management services

Under India's exchange control rules, charging management service fees to Indian residents in certain situations could require regulatory approval. It might be possible to obtain regulatory approval for such a charge, based on TP documentation proving

its arm's-length nature. Management service fees charged to Indian taxpayers are tax-deductible if charged on an arm's-length basis. Management charges to Indian taxpayers are generally scrutinised in detail during TP audits. To mitigate the risk of disallowance, the charges should be evidenced by extensive supporting documentation proving that the services were rendered and were necessary to the business of the recipient of the services (the benefit test). Where an Indian taxpayer is providing such services, the taxpayer should be compensated on an arm's-length basis.

Payment of royalty

The Government of India has permitted lump-sum fees for transfer of technology and royalty payments for use of trademarks/brand names and technology under the automatic route, without any restrictions. The objective of this change in policy is to freely promote the transfer of high-end technology into India.

This amendment in the exchange control regulations has had implications on the inter-company royalty arrangements that MNEs have with their Indian affiliates. Because of exchange control limitations, MNEs had in the past restricted the royalty charge to their Indian affiliates in line with the limits prescribed under the automatic approval route. With the removal of such a restriction, MNEs are considering revisiting their royalty arrangements with their Indian affiliates to align them with the arm's-length standard.

With this change in policy, a robust TP documentation for supporting the arm's-length nature of royalty payments would be of utmost importance to defend the deductibility of such payments before the Revenue.

Legal cases

Since the enactment of the TP regulations took effect from 1 April 2001, the Indian tax authorities have completed ten rounds of TP audits. There have been a few noteworthy judicial cases, which have established certain important TP principles, on treatment of excessive advertising, marketing and promotion (AMP) expenses, issuance of shares to foreign parent, determination of arm's-length interest rate for outbound loans denominated in foreign currency, selection of tested party, preference for transaction-by-transaction analysis over the aggregation of transactions approach, importance of functional similarity between tested party and comparables, and disregard of comparables having controlled transactions. Also, while the common issues like availability of contemporaneous data and use of secret comparables remain unsolved, the tax authorities have increased their focus on complex issues including intangibles, procurement models and cost allocations. Certain recently concluded eminent cases that have marked the TP landscape in India are summarised below:

Quark Systems Private Limited

The taxpayer is engaged in providing customer support services to an AE. In the TP documentation, the TNMM was applied as the most appropriate method for determining the arm's-length price. During the scrutiny audit, the Revenue rejected one company chosen as a comparable by the taxpayer on the grounds that the said company was in a start-up phase and had made losses for consecutive years.

Before the Appellate Tribunal, the taxpayer contested that once functional comparability is established the comparable should not be rejected on grounds like start-up phase, negative net worth, etc. In addition, the taxpayer argued for the rejection of one high-margin comparable company on the basis that the company had significant controlled transactions.

In its ruling, remanding the order back to the Revenue, the Appellate Tribunal upheld the need for a proper functional analysis of the tested party and the comparables in determination of the arm's-length price and objected to the selection of comparables merely on the basis of business classification provided in the database. The Appellate Tribunal also highlighted the need to follow principles of substantial justice, where the taxpayer should be given an opportunity to rectify a bona fide mistake, when it is based on facts on record.

The ruling emphasised that selection of comparables rests on a proper functional analysis and principle of substantial justice to be considered in applying the burden of proof. In addition, the Appellate Tribunal held that the taxpayer might reject its own comparable, chosen in the TP study on merits, in light of additional/substantive facts available at the time of a TP audit.

Skoda Auto India Private Limited

The main international transactions of the taxpayer involved the purchase of kits and payment of royalties, the pricings of which were justified using the TNMM as the most appropriate method. In addition, CUP method data (in the form of transaction price between the parent company and other group companies) was used as a corroborative analysis for the transaction of purchase of kits. The TPO rejected the application of the CUP method and further made an adjustment by disregarding certain comparables chosen by the taxpayer. At the Appellate Tribunal level, the taxpayer argued on the two major issues, i.e. differences in business models of comparable companies (full-fledged manufacturers) *vis-à-vis* the company (operating as an assembler) and low-capacity utilisation of the taxpayer as it was in the start-up phase.

The Appellate Tribunal laid down that economic adjustment (for capacity utilisation, unusual high start-up costs) should be made wherever necessary; the taxpayer cannot be expected to get detailed information, which is not available in the public domain. Further, the Appellate Tribunal held that approximations and assumptions can be relied on in the absence of information in the public domain for making the adjustments; and the benefit of the 5% range should be allowed to the taxpayer.

The principle of adjustment for high start-up costs enunciated in the judgment holds significant value for companies that are in their initial stage of operations. The ruling re-emphasises the fact that a comparison should be made after economic adjustments whenever necessary.

Fulford (India) Limited

The taxpayer imported active pharmaceutical ingredients (APIs) for secondary manufacturing of formulations. The TPO rejected the TNMM analysis undertaken by the taxpayer and considered the CUP method as the most appropriate method. The TPO compared the purchase price of APIs imported by the taxpayer from an AE with the price for which generic APIs were purchased by the taxpayer's competitors.

The taxpayer contended that the CUP method requires stringent comparability and any differences in the third-party price and the international transaction price which could materially affect the price in the open market, warrant appropriate adjustment to such third-party prices. In the pharmaceutical world, APIs might have similar properties but still could be different on quality, efficacy and levels of impurities present in the drug, among other things. As a result, the two products cannot be compared.

Further, the assessee imported the APIs from the AEs and performed secondary manufacturing functions, converting the APIs into formulations, and marketed and sold the formulations in the Indian market, and so, was akin to a value-added distributor. It was so entitled to a return for its distribution functions and secondary manufacturing functions, commensurate to its level of involvement for the relevant product.

The selection of the method should be based on functional analysis and the characterisation of the transactions and the entities. The CUP method cannot be applied here as the application of the CUP method is blatantly absurd. By applying the CUP method and reducing the import price, the TPO was expecting the assessee to earn an operating margin of 32.09% in the manufacturing AE segment, as compared to 11.37% earned in that segment. The profit earned in the AE segment was higher than the operating margin of 8.69% earned by the assessee in its non-AE segment.

As a result, the assessee made several arguments rejecting CUP as the most appropriate method and distinguished the prior Serdia Pharmaceutical ruling on a similar issue. In the said ruling, the Appellate Tribunal had stated that the arm's-length price of generic APIs can be computed using the CUP method, as long as comparables for application of the CUP method are available.

But in this ruling, the Appellate Tribunal did not make any adverse observations in relation to any of the arguments placed by the assessee. The Appellate Tribunal observed that the assessee's submission that it acted as a secondary manufacturer, which was akin to a 'value-added distributor', was not made before the lower authorities. Accordingly, the Tribunal opined that in the interest of justice, they deem it proper to restore the issue to the file of the AO for fresh adjudication.

IL Jin Electronics (India)(Private) Limited
The taxpayer is engaged in the manufacture of printed circuit boards for one of its group companies in India. The taxpayer imported 45.51% of its raw materials from its AE in Korea, while the balance of 54.49% was procured locally. The AE in Korea purchased these raw materials from unrelated vendors and charged a mark-up for its procurement services. The taxpayer adopted the TNMM and used the operating margin results of a set of comparable companies to demonstrate the arm's-length nature of the import transaction. During the audit, the TPO rejected certain high-loss-making comparable companies identified by the taxpayer and made an upward adjustment to the taxpayer's import prices by applying a higher arm's-length operating margin to the total turnover of the taxpayer.

The taxpayer contested before the Appellate Tribunal that in arriving at the arm's-length price for the import transaction, it is important to consider the actual purchase price paid by its AE to the unrelated vendors as well as the mark-up charged by its AE for its procurement services. In addition, the taxpayer argued that working capital differences between the taxpayer and the comparable companies needs to be considered in arriving at the arm's-length operating margin under the TNMM. Finally, the main contention of the taxpayer was that because only 45.51% of the total raw materials were imported from its AE, any upward adjustment to the import price should be based only on 45.51% of the taxpayer's turnover, not the total turnover.

The Appellate Tribunal observed that a different methodology for TP analysis taking a foreign AE as a tested party by applying the RPM or CPM would have been the ideal approach to determine the arm's-length price in the present case. But, in the absence of any supporting analysis/information presented in relation to the details of prices of the raw material purchased by the AEs from the third-party vendors by the taxpayer, the Appellate Tribunal held that the adoption of different methodology was not possible and hence, only the TNMM could be used as the most appropriate method.

The Appellate Tribunal agreed with the taxpayer that TP adjustment should be made based only on 45.51% of the turnover, not the total turnover. This ruling is important in the context of application of the TNMM, when the method has been applied on an entity-level basis where segmented financial data is not available with the taxpayer for transactions with its AEs. In such a case, any TP adjustment is to be made only on a proportionate basis and not on the basis of the total turnover of the taxpayer. The Appellate Tribunal also commented on use of foreign AEs as the tested party to determine the arm's-length price.

Cheil Communication India Private Limited

The taxpayer is primarily engaged in the business of rendering advertising services to its AEs against payment of commission. The taxpayer applied the TNMM to confirm the arm's-length price of the international transactions and selected operating profit/value-added expenses as the profit level indicator (PLI). As part of its business of providing consultancy services related to advertisement, the taxpayer also facilitates placement of such advertisements in the print/electronic media. For this purpose, the taxpayer makes payment to third parties including advertisement agencies and printing presses for booking of advertising space/time slots, etc., on behalf of its customers, namely its AEs, and recovers them from its AE.

In its audited accounts, the taxpayer recognises revenue on a net basis (i.e. it recognises the commission received as 'revenue' and treats the 'gross media spends' passed on to the customers/AEs as 'pass-through costs', thereby not including such third-party costs in its profit and loss account and operating margin computation). The TPO held that the PLI for comparability purposes should be taken as operating profit/total cost where total cost includes the costs of placing advertisements on behalf of the AEs, which costs were reimbursed by the AEs to the taxpayer on an actual basis.

The Appellate Tribunal accepted that the gross media spends paid to the media agencies do not represent the taxpayer's value-added activity and accordingly, mark-up is to be applied on the cost incurred by the taxpayer in performing the agency functions and not on the gross media spends. The Appellate Tribunal endorsed the OECD's view that while applying the TNMM, the costs to be considered should be the costs incurred in relation to the value-added activity (i.e. the costs relating to the agency function in the taxpayer's case).

This is the first Appellate Tribunal ruling in India on the treatment of pass-through costs. The ruling extensively relies on the OECD Guidelines and establishes the principle that in applying a cost-based remuneration model, a return or mark-up is appropriate only for the value-added activities. The Revenue authorities had appealed to the High Court against the ruling of the Appellate Tribunal. However, the High Court dismissed the Revenue's appeal, upholding the Tribunal ruling.

Gemplus India Private Limited
The taxpayer is a part of the Gemplus group, which is engaged in providing smart-card solutions for the telecommunications industry, financial services industry and other e-businesses. The taxpayer entered into a management services agreement with its AE for receipt of services in marketing and sales support, customer service support, finance, accounting and administration support, and legal support.

The TPO observed that there was no clear proof that such services had actually been rendered by the AE. There was no specific benefit derived by the Indian entity. The taxpayer had not established the necessity for availing these services from the AE and had already incurred expenses towards professional and consultancy services, and employed qualified personnel in India for rendering similar services. The volume and quality of services were disproportionate to the amount paid, and the charge was based on cost apportionment among the group entities on a mutually agreed basis and not on the basis of actual services rendered.

The Appellate Tribunal decided the case in favour of the Revenue. This ruling has laid down some critical principles applicable for service transactions, which would in fact apply to any transactions involving intragroup services or intangibles. Simply put, to satisfy the arm's-length standard, a charge for intragroup services or intangibles is justified only when the need for intragroup services or intangibles is established, or, the intragroup services or intangibles have actually been received, or, the benefit from intragroup services or intangibles is commensurate with the charge.

It might be noted that in the case of Dresser Rand India Private Limited, the Appellate Tribunal held that the commercial wisdom of the taxpayer cannot be questioned in deciding the necessity for availing such services. However, a few principles that are common in both the rulings are documentary evidences to establish actual receipt of services and cost incurred must be commensurate with expected benefits. Reliance Industries Limited

The taxpayer hired a vessel from its AE and paid time charter hire charges, based on a PDR. To establish the arm's-length price of the transaction, the taxpayer relied on the approval received by the Directorate General of Shipping (DG Shipping) and contended the same as the CUP. Further, the taxpayer also relied on a monthly charter hire rate, indicated in the Drewry Monthly Report by contending that the PDR paid by the taxpayer was reasonable, taking into account that the vessel provided by the AE was of less capacity, i.e. 2,242 cubic metres, as against the rate published in the Drewry Monthly Report, which was for a capacity of 3,000 cubic metres.

The TPO considered published prices in the shipping publications, the Shipping Intelligence Weekly and the Drewry Monthly Report, and arrived at their arithmetic mean. Further, the TPO made a prorated adjustment for the difference in capacity and determined the arm's-length price, without considering any technical and commercial factors.

The Appellate Tribunal held that in the absence of comparable transactions (i.e. in view of the unique vessel, with no comparable ships available), the matter should be set aside to the file of the Assessing Officer for the limited purpose of recomputing the arm'-length price by taking the data available in the public domain, in the form of publication of Shipping Intelligence Weekly and Drewry Monthly as a 'comparable price', and adjusting it for differences in weight, capital cost, risk, etc.

The ruling reiterates the important principle that in the absence of actual transaction, which can be considered as CUP, the data available in the public domain can be considered as a 'comparable price' after making adjustment for the differences.

GAP International Sourcing (India) Private Limited
The taxpayer was engaged in facilitating the sourcing of apparel from India for its group companies. The primary activity of the taxpayer comprised of assistance in identification of vendors, provision of assistance to vendors in procurement of apparel, inspection and quality control, and coordination with vendors to make sure of delivery of goods to group companies.

The necessary technical and intellectual inputs for the discharge of these services were provided by the group companies. The taxpayer adopted the TNMM to benchmark the service fee determined at full cost plus 15% from the foreign group company for its TP documentation. During the TP audits, the TPO disregarded the functional profile and characterisation of the taxpayer by assuming that the functional profile of the taxpayer was substantially higher than those of limited risk support service providers.

The TPO alleged that a cost plus form of remuneration did not take into account substantial intangible assets owned by the taxpayer. These intangibles were primarily construed by the TPO to be in the nature of human asset intangibles, supply chain intangibles and location savings. Based on the above, the TPO ascertained that the taxpayer ought to have earned a commission of around 5% on the FOB value of the goods procured by the group companies.

The Appellate Tribunal has stated that for determining the arm's-length price of every international transaction, it is imperative to take the characterisation of the taxpayer and its AEs into consideration through functional analysis of international transactions. While stating this, the Appellate Tribunal has observed the following specifically for the taxpayer's case:

- No significant business risks were borne by the taxpayer.
- The taxpayer did not have capacity to assume business risks.
- No human resource intangibles were developed by the taxpayer.
- No supply chain intangibles were developed by the taxpayer.
- Location savings could not be attributed to the taxpayer.

In view of all of the above, the Appellate Tribunal held that the arm's-length cost plus mark-up for the taxpayer should be 32%, as opposed to the exorbitant numbers (830% and 660% for the two years under consideration) imputed by the TPO in a derived manner, by resorting to a commission-based model of 5% on the FOB value of goods procured by the AE directly from Indian vendors.

The Appellate Tribunal has acknowledged that procurement companies might have different remuneration models, based on their functional profiles (e.g. cost plus, commission or buy–sell margin), so it is important to make sure that the arm's-length price is determined, using the appropriate PLI and suitable benchmarking method. The arm's-length price as determined by either the taxpayer or the Revenue cannot lead to manifestly absurd or abnormal financial results, as had happened in the present case.

L'Oréal India Private Limited
The taxpayer is engaged in manufacturing and distribution of cosmetics and beauty products. In respect of the distribution segment, i.e. the international transaction of purchase of finished goods, the taxpayer had applied the RPM by benchmarking the gross margin of the taxpayer at 40.80% against that of comparables at 14.85%. The TPO rejected the application of the RPM by the taxpayer on the basis that the taxpayer was consistently incurring losses and the gross margins cannot be relied on because of product differences in comparables. Accordingly, the TPO adopted the TNMM.

The taxpayer contended that it was following market penetration strategy since the commencement of its distribution segment while the comparables had been present in the Indian market long since and had established themselves firmly in the Indian market.

The Appellate Tribunal observed that the taxpayer buys products from its AEs and sells to unrelated parties without any further processing, and, as per OECD Guidelines, in such a situation, the RPM is the most appropriate method. The taxpayer had also produced certificates from its AEs that margins earned by AEs on supplies to the taxpayer were 2% to 4% or even less. The Revenue had not disputed these certificates. So, the TPO's contention that the AEs have earned higher profit was not based on facts. On the other hand, profit earned by the AEs was also reasonable and hence there was no shifting of profits by the taxpayer to its AEs.

In this ruling, the impact of business strategies has been appreciated and operating losses were not attributed to non-arm's-length nature of international transactions. The Revenue authorities have appealed to the High Court against the ruling of the Appellate Tribunal. The High Court dismissed the Revenue's appeal, thereby confirming the Tribunal ruling.

TNS India Private Limited
The taxpayer was engaged in conducting quantitative and qualitative market research. It had entered into several international transactions, out of which the TPO disputed the 'payment of management fees' to the AE by questioning the benefits received from the AE and hence determined the arm's-length remuneration for such management fees to be nil.

The taxpayer submitted various facts and documents to justify the benefits of the various services/processes/know-how/systems/knowledge that were available to the taxpayer on a real-time and continuous basis which warranted the payment of management fees. The taxpayer further submitted evidences relating to the access to AE's in-house skill and expertise, know-how and technology, which were beneficial to the activities of the taxpayer and were influential in enhancing the efficiency of the taxpayer.

The Appellate Tribunal observed that the taxpayer has placed sufficient evidence in support of its claim, such as a detailed write-up of services provided and benefit received. The Appellate Tribunal observed that providing concrete evidence with reference to services in detail would be difficult as these are intangible in nature; however, by the way business is conducted, one could perceive the same. The Appellate Tribunal observed that the TPO cannot reject the payment of management fees outrightly, which is beyond their jurisdiction. The TPO cannot question the business decision of the payment. As the management fee was considered while determining

the PLI for the taxpayer under the TNMM, adjustment on the same account was not warranted.

The recognition of the Appellate Tribunal that it could be difficult to produce ‘concrete’ evidence to demonstrate the rendition of services and benefits availed, as they might not be in tangible form, is most reassuring and a welcome outcome of this ruling. It also worth noting that documentary evidence filed by the taxpayer was not only acknowledged by the Appellate Tribunal, but was considered as sufficient and adequate regarding the payment of management fees.

Global One India Private Limited
The taxpayer along with its group companies was engaged in providing services of seamless connectivity and data transmission for their global customers. As per the group’s management, each of the subsidiaries would participate in, and contribute, unique intangibles, and/or transactions between them were so interrelated that the same could not be examined separately to determine the arm’s-length price of any single transaction under any ‘one-sided’ testing.

Hence, the group resorted to the residual profit split method (RPSM) as the TP method for all its subsidiaries situated across the world. First standard or routine returns for the routine functions performed by each subsidiary were computed. The second step was to split the overall residual profits or losses of the group amongst various subsidiaries in proportion to actual costs incurred by each of subsidiaries, after giving common weighting to the three significant intangibles, which were owned by various subsidiaries. These were: (i) sales and marketing operations, (ii) network assets and operations, and (iii) field operations.

The revenue authorities rejected the application of the RPSM and alleged that the taxpayer is a mere service provider for its overseas affiliates and so should have been remunerated as a service provider, and hence the TNMM should be adopted. Further, Indian TP regulations provided mandatory application of the ‘Comparable PSM’, and accordingly, the taxpayer had to demonstrate the splitting of residual profits with reference to actual uncontrolled transactions, failing which, RPSM cannot be applied by any taxpayer in India.

The taxpayer argued that the facts of the case clearly suggested that the taxpayer contributed to, and participated in, unique intangibles, being the valuable network of the Global One Group, and further, the transactions between Global One India and its foreign fellow subsidiaries were so interrelated that the same could not be examined separately to determine the arm’s-length price of any single transaction under any ‘one-sided’ testing. As a result, Global One India could not be held to be a service provider for being subjected to the TNMM. On the other hand, its case per se fell within the ambit of the PSM.

The Appellate Tribunal accepted the aforesaid factual matrix offered by the taxpayer with the resultant corollary that the case of the taxpayer per se fell with the purview of the PSM.

The taxpayer admitted before the Appellate Tribunal that Indian TP regulations prescribed that a taxpayer could adopt i) the contribution PSM or ii) the residual PSM, which needs to be supplemented by a comparable PSM. In this context, the taxpayer argued that the PSM prescribed by Indian TP regulations is quite unique as compared to OECD and UN TP Guidelines, wherein flexibility to the taxpayer is provided to adopt any of the following sub-methods under the overall PSM, namely i) the contribution PSM or ii) the residual PSM or iii) the comparable PSM; however, as per Indian TP regulations, a taxpayer needs to adopt a comparable PSM to supplement either the contribution PSM or the residual PSM.

The requirement of Indian TP regulations to mandatorily use the comparable PSM to split entrepreneurial profits would actually make the PSM virtually redundant in most cases, since it is not possible to obtain reliable market data on third-party behaviour in the matter of splitting profits, except in some rare cases of joint venture agreements. In the instant case where knowledge of third-party behaviour is impossible to possess and the case in which otherwise deserves treatment of the PSM, then prescription to mandatorily use a comparable PSM would render the whole machinery of the PSM under TP regulation a nullity and impossible to be implemented.

As a result, the taxpayer argued that where a case deserved to be otherwise covered, either a contribution PSM or residual PSM, then it should not be denied with such methodology merely due to the fact that Indian TP regulations provided for the mandatory usage of the comparable PSM as a supplement to the contribution PSM or residual PSM. This is because impossibility of performance provided under a statute had to be dispensed with and a purposive interpretation, which would give 'life and force' to statute without changing its basic fabric should be adopted. As a result, in deserving cases, as in the case of a taxpayer, a residual PSM has to be applied without resorting to a comparable PSM.

The Appellate Tribunal accepted the above arguments relating to applicability of the residual PSM. The Appellate Tribunal also accepted the taxpayer's alternative arguments in respect of the 'other method' as introduced by the CBDT with effect from 1 April 2012, which was meant to remove lacuna and hardship, latent in the Indian TP regulations.

This is a landmark ruling by the Appellate Tribunal, wherein application of the PSM has been dealt with great maturity and the Appellate Tribunal not only accepted the purposeful interpretation for a meaningful application of the residual PSM, but also accepted the taxpayer's alternative argument that if the PSM, as applied by the taxpayer, did not fall within the strict definition of the PSM as provided under Indian TP regulations, then the same should be considered as 'other method', which has been inserted to remove lacuna and hardship in Indian TP regulations.

Maersk Global Centers (India) Private Limited

The taxpayer was engaged in the business of providing shared services and rendered transaction processing, data entry, reconciliation of statements, audit of shipping documents and other similar support services. The taxpayer was also rendering information technology-enabled services, such as process support, process optimisation and technical support services.

The TPO observed that the taxpayer was providing services like documentation, finance, operations, logistics, global information systems, etc. The TPO noted that the taxpayer was also rendering logistic outsourcing services and business analytic services, which involved transfer of knowledge-intensive processes and significant domain expertise. Accordingly, the TPO classified the services as knowledge/expertise-based and characterised the same as knowledge process outsourcing (KPO) services and determined the arm's-length price and made an adjustment to the transfer price of the taxpayer. Aggrieved by the adjustment, the taxpayer filed an appeal before the Appellate Tribunal, requesting to examine whether KPO comparables can be considered for benchmarking the arm's-length price of back-office support function and whether comparables earning abnormally high margins should be included in the list of comparables.

The Appellate Tribunal, while adjudicating the matter, ruled on various important aspects of Indian TP regulations:

- Bifurcation of information technology-enabled services (ITeS) in business process outsourcing (BPO) and KPO services: The Appellate Tribunal observed that BPO services are generally low-end services while KPO services are identified as high-end and hence there exists some difference between the two services. But the range of services rendered by the ITeS sector is so wide that a classification of all services, either as low-end or high-end might not always be possible.

  The Appellate Tribunal observed that there could be significant overlap between ITeS activities with some activities being very fact sensitive. "Therefore, introducing an artificial segregation within ITeS may create more problems in comparability analysis than resolving the same. Accordingly, it held that ITeS cannot be further bifurcated/classified as BPO and KPO services for purposes of comparability analysis."
- Exclusion of abnormally high profit margin comparable companies: The Appellate Tribunal observed that the Indian TP regulations specifically deviate from the OECD Guidelines, which provides for an interquartile range of benchmark results that automatically excludes outliers as compared to the use of the arithmetic mean provided in the Indian TP regulations for determination of the arm's-length price. It held that merely because a comparable has shown abnormal profits, the same cannot be a ground for its exclusion and also held that potential comparables earning abnormally high-profit margins should trigger further investigation.

Delhi High Court ruling on marketing intangibles in the case of Sony Ericsson Mobile Communications India Pvt. Ltd and Others

For several taxpayers in India, the Revenue authorities alleged incurring of 'excess' AMP expenses, thereby creating a marketing intangible for the AE. The AE was required to compensate the taxpayer for such brand building services along with a mark-up. The 'excess' was measured with respect to the AMP spend of comparable companies. This rationale, applied by Revenue authorities, was largely upheld by the Special Bench (SB) of Delhi Tribunal in the case of LG Electronics (LG ruling), which was consequently applied to several interveners in that case who were parties to the proceedings before the SB, and was later followed in the cases of many other taxpayers.

The appeals before the Delhi High Court (HC) were filed by various affected taxpayers (most of whom were interveners before the SB) against the Division Bench rulings in their respective cases, wherein essentially the ratio of the LG ruling was applied regardless of their individual fact pattern.

The aggrieved taxpayers were engaged in distribution and marketing of imported and branded products, manufactured and sold to them by foreign AEs resident abroad. Intangible rights in the brand-name/trademark/trade-name were owned by the foreign AEs. The taxpayer incurred significant AMP expenses in India and contested that this expenditure is not an international transaction as defined in the Act.

While deciding on the issue of marketing intangible, the HC has held:

- Excess AMP spend by Indian subsidiaries of MNEs represent an international transaction, which needs to be evaluated under the arm's-length principle.
- The issue of marketing intangibles requires an in-depth factual analysis, depending upon the functional, asset and risk profile of each taxpayer and its associated enterprise. A common dictum, on merits, which would apply across the board as per the LG ruling, was dismissed by the HC.
- It was not statutory mandate to subject the AMP to a 'bright line' test and consider non-routine AMP as a separate transaction. The HC concluded that marketing and distribution functions were closely connected, and hence could be bundled for determining arm's-length price. Further, where, on testing the bundled transaction under either TNMM or RPM with appropriate comparables, it was concluded that the transactions were at arm's length, there was no need to bifurcate and look at AMP as a separate transaction.
- It would be wrong to assert and accept that gross profit margins under RPM would not inevitably include AMP. The gross profit margins could remunerate an AE performing marketing and selling function. This had to be tested and examined without any assumption against the taxpayer.
- For complex entities, or where one of the entities was not a 'plain vanilla distributor', TNMM had to be applied when necessary, and comparables with or without adjustments were available. Otherwise, TNMM should not be adopted or applied on account of being an inappropriate method.
- TNMM would not be the most appropriate method when there were considerable value additions by the subsidiary AEs.
- For applying Resale Price Method, comparables performing comparable AMP spend must only be selected.
- Brand building is not equivalent to advertisement and sale promotion. In the context of licensed manufacturers facing similar issues, this would be relevant, as the brand value not only consists of the trademark or trade name but is also a contribution of infrastructure, know-how, ability to compete, etc. HC also ruled that routine or day-to-day marketing or sale promotion expenses, even when excessive and exorbitant, would not amount *per se* to 'brand building'.
- The HC has also dealt with the concept of economic vs. legal ownership, and in doing so has provided sanctity to concept of economic ownership per se wherein it held that economic ownership of a brand was an intangible asset, just as legal ownership. Although dealt with in the context of distributors, the concept of economic ownership is far more relevant for licensed manufacturers.

Accordingly, the HC Ruling on marketing intangibles has addressed many important contentious issues and will go a long way in boosting the confidence in the Indian judiciary as the guiding force for laying down the right principles on the subject of transfer pricing.

Vodafone India Services Private Limited/Shell India Markets Private Limited
The taxpayer issued equity shares to its AE at a premium. Revenue contested the valuation of the equity shares and valued it at a much higher amount. Revenue treated this shortfall amount as income chargeable to tax basis that forgoing of premium on the part of the taxpayer amounts to extinguishment/relinquishment of a right to receive fair market value. It further treated this amount as a deemed loan given by the Petitioner to its holding company and calculated periodical interest on contention that if the petitioner had received the extra premium, it would have invested it in alternate avenues and would have earned additional income.

The taxpayer argued that pre-requisite for application of TP Regulations is that the income should arise from an international transaction. In this case, no income arises from issue of equity shares as the same is capital receipt and not a revenue receipt. Further, issue of equity shares does not have any impact of income on account of business restructuring/reorganising.

The HC ruled that the transaction of issue of shares by the taxpayer is a capital account transaction, and consequently the share premium, if any, ought to be a capital receipt. The TP provisions permit a transaction to be re-quantified but not to be recharacterised. Hence, there was no question of the transaction resulting in 'income' taxable in India.

Cotton Naturals (I) Private Limited
The taxpayer, engaged in the business of manufacture and exports of rider apparels, had advanced a foreign currency denominated loan to its AE in the US at 4% per annum. The AE, to whom the loan was granted, was a subsidiary undertaking distribution and marketing of the taxpayer's products and the loan was granted to meet the working capital requirements of the AE in order to continue its business activities smoothly. The interest rate was benchmarked to be on an arm's-length basis by the taxpayer on the basis that the rate was comparable to the export packing credit rate obtained from independent banks in India.

The Revenue authorities contended that lending and borrowing was not the main business of the taxpayer and LIBOR was not proper reference to calculate the corresponding interest on outbound loan. Accordingly, it recomputed the arm's-length rate of interest in line with domestic Prime Lending Rate (PLR) in India, being the taxpayer's opportunity return on the funds if deployed in the domestic market.

The HC ruled that role of Revenue authorities was restricted to determination of arm's-length price of the international transaction and not to restructure the transaction to determine the maximum return taxpayer can earn on such loan amount from other sources. Since it was a prevalent practice among multinational companies to incorporate subsidiaries outside India for undertaking functions such as distribution and marketing, in view of Rule 10B and Rule 10C of the Income-tax Rules 1961 (Rules), the comparison has to be with what independent entities would pay under identical circumstances, and not with the choices available to the taxpayer for earning the maximum returns by restructuring the transaction. The High Court further held

that arm's-length interest rate needs to be the market-determined rate applicable to the currency in which the loan has to be repaid during the period in which loan was granted to AE.

Comparison with OECD Guidelines

India is not a member of the OECD. However, India has been invited to participate as an observer in the OECD's Committee on Fiscal Affairs, which contributes to setting international tax standards, particularly in areas like tax treaties and TP. India's TP regulations broadly adopt the OECD principles. Tax offices have also indicated their intent of broadly following the OECD Guidelines during audits, to the extent the OECD Guidelines are not inconsistent with the Indian TP Code.

48.

Indonesia

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Overview

Indonesia has adopted the arm's-length standard for transactions between related parties. As the tax system is based on self-assessment, the burden of proof lies with the taxpayer, not with the tax authorities.

Indonesia is not an Organisation for Economic Co-operation and Development (OECD) member. However, the OECD Guidelines are widely accepted as authoritative guidance on transfer pricing (TP) by both taxpayers and tax administrations in OECD member countries and are commonly used as guidance by other countries including Indonesia.

For income tax purposes, the legislation dealing with TP is found in Article 18 of the 1983 Income Tax Law, which stipulates that the tax authorities may adjust a taxpayer's taxable income for related-party transactions that were not carried out on an arm's-length basis. The statutory TP documentation requirement was initially stipulated in Government Regulation No.80/2007, which explicitly states that taxpayers engaging in transactions under common control must maintain documentation that proves their adherence to the arm's-length principle. The TP legislation applies to both cross-border inter-company transactions and domestic inter-company transactions (The Director General of Taxation [the DGT] Regulation number PER32/PJ/2011 (PER-32) stipulates that domestic related-party transactions are also covered in the purview of the TP regulations if the related parties are effectively not taxed on the same basis).

Country	**Indonesia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No

Indonesia

Country	Indonesia
When must TP documentation be prepared?	Ideally before the submission of the Corporate Income Tax Return
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Penalties of 2% per month are imposed for late payment of tax, up to a maximum of 48% of the unpaid tax.

Introduction

In Indonesia, the preparation of TP documentation only serves as the first line of defence. There is a possibility that the Indonesia Tax Office (ITO) may arrive at different conclusions. Given this circumstance, it is not guaranteed that the ITO will automatically accept that the transfer prices and arrangements established in the taxpayer's TP documentation are in accordance with the arm's-length principle. The prevailing Indonesian TP regulations stipulate that TP documentation shall be submitted by the taxpayer at the time they are required for taxation purposes such as tax audits. In the event of tax audit, the 2007 Tax Administration Law stipulates that documents formally requested in a tax audit (including TP documentation) must be delivered within one month of the request. Currently, there are no specific regulations stipulating that TP documentation must be prepared in the official/local language. In practice, TP documentation prepared in English is acceptable for the ITO. However, in the event of tax litigation, sometimes taxpayers are required to prepare a translation of its TP documentation into the local language. Furthermore, taxpayers are required to disclose all its related-party transactions in its annual corporate income tax return.

Currently, there is no regulation stipulating direct penalty for not complying with TP documentation requirements. However, in the event that the taxpayer fails to comply with the TP documentation requirement, the ITO is eligible to use its right to determine the arm's-length nature of the taxpayer's related-party transactions, based on Article 18 paragraph (3) of the Income Tax Law. As such, practically it is very difficult to defend the taxpayer's TP position in the absence of TP documentation during the tax litigation process.

Legislation and guidance

For income-tax purposes, the legislation dealing with TP is found in Article 18 of the 1983 Income Tax Law, as revised by the 1991, 1994 and 2000 income tax laws and further by Income Tax Law No. 36/2008.

Article 18 states that the tax authorities may adjust a taxpayer's taxable income for related-party transactions that were not carried out on an arm's-length basis. Related parties are deemed to exist in the following circumstances:

- Where a taxpayer directly or indirectly participates in 25% or more of the capital of another taxpayer, or where a company participates in 25% or more of the capital of two taxpayers, in which case the latter two taxpayers are also considered to be related.
- Where a taxpayer directly or indirectly controls another taxpayer or where two or more taxpayers are under common control.
- Where there is a family relationship by blood or marriage.

Article 18 (3) of the Income Tax Law provides that the five arm's-length pricing methodologies from the OECD Guidelines should be used to set or review transfer prices.

For value-added tax (VAT), a virtually identical provision is included in Article 2 of the 1983 VAT Law, as revised by the 1991, 1994 and 2000 VAT laws and further revised by VAT Law No. 42/2009.

Penalties

Penalties of 2% per month are imposed for late payment of tax, up to a maximum of 48% of the unpaid tax. In criminal cases, fines of 200%–400% of the unpaid tax are possible, as is imprisonment.

Documentation

Legal basis

Government Regulation No. 80/2007, which was issued 28 December 2007 and effective from 1 January 2008, explicitly states that taxpayers engaging in transactions under common control must maintain documentation which proves their adherence to the arm's-length principle.

The 2007 tax administration law states that documents requested in a tax audit must be delivered within one month of the request. This could mean that TP submitted after 30 days can be ignored.

In late 2010, the Indonesian DGT issued several important TP regulations, laying the foundation for a new era of TP development in Indonesia. The TP regulation, PER-43/PJ/2010 (PER-43), represents the first specific TP guidance to Indonesian taxpayers since TP documentation became mandatory 1 January 2008.

PER-43 was amended by PER-32 on 11 November 2011, which provides additional guidance on comparability analysis required in the TP documentation, preference towards internal comparables over external comparables and application of the most appropriate method as compared to the hierarchical approach in selecting TP methodology under PER-43. The regulation also mentioned that PER-32 is only applicable to transactions exceeding IDR 10 billion with a single related party. Domestic related-party transactions are also covered in the purview of the TP regulation if the related parties are effectively not taxed on the same basis.

The above amendment was in addition to the regulations released in 2010 on the mutual agreement procedure (MAP), PER -48/PJ/2010 (PER -48); and the advance pricing agreement, PER-69/PJ/2010 (PER -69). Recently the Government has issued Ministry of Finance (MoF) Regulation No.240/PMK.03/2014 (PMK-240) regarding the implementation of the MAP and MoF Regulation No.7/PMK.03/2015 (PMK-7) regarding the implementation of APA.

PER-22/PJ/2013 (PER-22) was issued by the DGT on 30 May 2013, which pertains to the tax audit guidelines for taxpayers with special relationship. One of the notable highlights in PER-22 is that during the tax audit, taxpayers will be required to complete several detailed forms, which include comparability analysis, functions, assets and risks (FAR) analysis, information to the audited party's business environment, supply chain management analysis, segmented financial data from transactions with related party and those with independent parties and a signed statement letter by the company's board of management confirming the accuracy of the information provided.

The forms required to be completed in PER-22 are listed below:

- Form A. Letter of information or data request.
- Form B. Statement letter.
- Form C. Related party transactions.
- Form D. Segmented financial statements.
- Form E. Supply chain management analysis.
- Form F. Functions, assets and risks analysis (FAR analysis).
- Form G. Business characteristics.
- Form H. Comparability analysis.
- Form I. Letter of summons to provide information of affiliate transaction.
- Form J. Minutes of meeting for taxpayer's explanation on affiliate transactions.

The DGT also issued circular letter number SE-50/PJ/2013 (SE-50), effective 24 October 2013 to provide technical guidelines on tax audits focusing on TP-related matters. While SE-50 aims to standardise the approach and nature of documents to be reviewed by tax auditors during the tax audit process focusing in TP-related matters, it essentially re-emphasises the importance of maintaining robust TP documentation in a timely manner to facilitate the tax audit process.

Implementation of arm's-length principle

PER-32 indicates that the arm's-length principle should be implemented using the following steps:

- Perform a comparability analysis and identify comparables.
- Determine the most appropriate TP method.
- Apply the arm's-length principle to the tested transaction, based on the result of the comparability analysis and the selected TP method.
- Document each step of the process used to determine the arm's-length price or profit.

Selection of TP methods

PER-32 has abandoned the hierarchy approach and adopted the most appropriate method approach, though from a practical perspective, the DGT still considers the comparable uncontrolled price (CUP) to be the most preferred method. The selection of the most appropriate method requires the following considerations:

- The strength and weakness of each TP method.
- The appropriateness of the method, based on the nature of the related-party transaction, determined by a functional analysis.
- Availability of valid information (on independent transactions) to apply the selected method.
- The comparability level between related-party transactions with independent transactions including whether any appropriate adjustments would need to be made to eliminate any material differences between the compared transactions or enterprises.

Comparability analysis

The comparability analysis outlined in PER-43, which has been amended by PER-32, is based upon the five comparability factors contained in the OECD Guidelines.

Guidance is provided on how each of these comparability factors should be analysed. The guidance is consistent with explanations of the comparability factors in the OECD Guidelines. It is common practice for regional benchmark studies to be leveraged in Indonesian TP studies.

The Indonesian TP regulations also provide guidelines on assessing the arm's-length nature of intra-group services, intangible property, and inter-company loans transactions. Tests must be applied in a hierarchical manner to prove the arm's-length nature of intra-group services, intangible property and inter-company loans transactions.

Transfer pricing controversy and dispute resolution

Burden of proof

Indonesia operates on a self-assessment system, with companies setting their own transfer prices. The burden of proof lies with the taxpayer to prove that their transfer price has been set at arm's length. In a tax audit context, if a taxpayer does not have documentation to support its position, there is a high risk that the ITO will make substantial adjustments, such as the denial of all deductions for management services fees, or royalties paid to related parties.

Tax audit procedures

Audits are a significant feature of tax administration in Indonesia because of the self-assessment system. For the years preceding 2007, the tax office has ten years (but no later than 2013) within which to audit and issue assessments (and additional assessments if new facts, previously undisclosed, are found). For the years from 2008 onwards, the timespan for the issuing of underpaid tax assessment letters has been reduced to five years.

So far, the tax authorities have not undertaken any audits specifically relating to TP. Nevertheless, tax audits conducted in relation to overall tax compliance will invariably focus on inter-company transactions, especially transactions involving non-residents. Where there appear to be price discrepancies between intragroup transactions and third-party transactions, corrections of transfer prices will be included in the audit findings.

The ITO has been strictly enforcing the 30-day rule in tax audits. In practice, if a taxpayer has not prepared TP documentation prior to receiving a request in an

audit, it is likely to find it difficult to provide a satisfactory response within the 30-day timeframe.

Tax audits are conducted through desk reviews as well as visits to company premises by the tax authorities. These may involve meetings or correspondence, and settlement of the TP audit may in many cases take place through formal negotiation and appeal at the tax court. The conduct of the taxpayer may influence the outcome.

The tax authorities also have the power to perform investigations. Investigations are generally used only where fraud or evasion is suspected. Experience has shown that the main trigger of an investigation by the tax authorities has been information obtained by them through their information network, or provided to them by informants, such as disgruntled former employees.

Selection of companies for audit

Indonesia has an extensive system of tax audits. Taxpayers claiming refunds are automatically subject to tax audits. A tax return that indicates a loss generally also triggers a tax audit. In addition, the ITO has recently commenced a risk-profiling exercise designed to identify high-risk candidates for TP audits. Risk factors include losses (or poor profit performance compared to industry norms) and high volumes of related-party transactions. Recently, the ITO has released internal circular/notification in relation to tax audit revenue targets for 2015 and indicated that TP audits would be a key focus for generating tax revenues. Further, additional focus would also be on taxpayers engaged in mining and oil and gas industry sectors apart from multinational corporations.

The provision of information and other duties of a taxpayer

The tax authorities have wide-ranging statutory powers to call for information relevant to an audit, such as accounting records, agreements, supporting documents and tax returns.

Tax objections and the appeals' procedure

Tax auditors adjust related-party transactions where they do not believe an arm's-length price has been used. Taxpayers have the right to object to assessments made by the tax office. The objection must be lodged in writing within three months of the issuance of the assessment and should be addressed to the DGT at the particular office from which the assessment was issued. The DGT has 12 months to issue a decision in relation to the objection.

Under the 2007 Tax Administration Law, which was effective from 1 January 2008 (and applies to fiscal years beginning on, or after, this date), taxpayers are required to pay only an amount agreed with the tax auditors during the tax audit's closing conference. If the taxpayer does not agree with any of their corrections, it need not pay anything at this point.

However, taxpayers need to take care when deciding how much to pay, because an unfavourable DGT decision on their objection results in an administrative penalty of 50% of the underpaid tax. The penalty increases to 100% if an appeal is lodged and the decision is not in the taxpayer's favour.

Taxpayers may appeal to the Tax Court against DGT decisions on their objections. To have the Tax Court hear the appeal, the taxpayer must pay 50% of the total tax

assessment. There is uncertainty over the minimum amount to be paid for filing an appeal. According to the 2007 Tax Administration Law, the same rule should apply: taxpayers pay only as much as agreed in the closing conference. However, the Tax Court Law, which governs tax appeals, demands a minimum payment of 50% of the tax due. Notwithstanding the above, we note from some experiences of taxpayers, the court judges did not throw out taxpayers' cases on a technicality when the 50% minimum payments have not been satisfied.

Currently, the Tax Court gives taxpayers their best chance of receiving a fair hearing. If an appeal to the Tax Court is still unsuccessful, taxpayers may lodge reconsideration (judicial review request) to the Supreme Court, provided that certain criteria are met.

It is worth noting that Indonesia has a civil law system in which the courts do not operate on the basis of precedence and their decisions are not published. Furthermore, tax cases cannot be appealed beyond the Tax Court or Supreme Court or in any civil court other than the State Administrative Court. This court deals with complaints by persons adversely affected by Government decisions and has rarely, if ever, been used in tax cases.

Risk transactions or industries

There are no excluded transactions. For certain industries where it may be difficult to establish levels of actual profit arising in Indonesia, tax authorities have the power to impose taxes based on deemed profit. Marine or international aviation companies, oil and gas drilling companies, and foreign representative offices are included under this principle/regulation (Article 15 of the 1983 Income Tax Law, as revised by the 1994 and 2000 Income Tax Law and further by Income Tax Law No. 36/2008).

Although most of the TP issues challenged in tax audits in Indonesia have focused on cross-border TP, the law also covers TP that takes place within the country. Examples of where the tax office may use these provisions are in respect of luxury sales' tax imposed on domestically produced luxury goods, transactions subject to VAT, or profit shifting to utilise losses.

Taxpayers are not required to submit their TP documentation together with the annual income tax return. However, the taxpayers must disclose transactions with related companies in their annual income tax returns. The disclosures are quite detailed and include information such as whether TP documentation has been prepared.

The statement requires taxpayers to disclose the following details about their transactions with related parties:

- With whom the transaction is made and the nature of the taxpayer's relationship with the counterparty.
- The type of transaction.
- The value of the transaction.
- Which method was applied in determining the relevant transfer price (one of the five arm's-length TP methods recognised in the OECD Guidelines must be disclosed for each transaction), and the rationale for the choice of that method.

It is currently unclear whether the tax authorities will use these disclosures to select candidates for tax audits focusing on TP, as has been the practice in other countries where disclosures are required.

Limitation of double taxation and competent authority proceedings

The competent authority process has been increasingly used in Indonesia, because TP assessments have become more common over the last few years.

The ITO had received a number of competent authority requests arising from TP assessments in the previous year. Given the increase in TP audit activity and assessments raised by the ITO, it is likely that the number of competent authority cases will continue to increase in the future.

The recently issued PMK-240 regarding the implementation of the MAP as mandated under Article 59 of Government Regulation No.74 year 2011 (GR-74) effective from 22 December 2014 and is applicable for all outstanding and future MAP implementation under tax treaties. The contents of PMK-240 reflect a refinement and changes to the guidelines stipulated in PER-48 for a MAP facility governed under the tax treaties.

PMK-240 clarifies that a MAP application can be submitted within the time limit as specified in the relevant tax treaty by:

- a taxpayer through the DGT
- the DGT, or
- the tax authority of the treaty country or jurisdiction.

The request for MAP must be submitted in written form to the Directorate of Regulation II (the Director II) at the DGT head office and also require submission of Certificate of Domicile of the relevant foreign taxpayer from the treaty country or jurisdiction.

Previously, GR-74 stipulated that taxpayers can apply for a MAP and simultaneously pursue local dispute resolution mechanism. The local dispute resolution includes applying for a tax objection, appealing to the Tax Court and requesting for a reduction or cancellation of administrative sanctions. However, PMK-240 stipulates that once the Tax Court declares an end to the court hearing process (i.e. when the Tax Court determines it has sufficient information to make a judgment), regardless of the outcome of the Tax Appeal, the DGT will discontinue the process of the existing MAP application. If one of the parties is not satisfied with the Tax Court decision, a judicial review by the Supreme Court is still allowed.

PMK-240 also provides the timelines for the filing of the MAP application and also the timeframe for conclusion of consultation with the tax treaty partner country. The timeline to file the MAP application is as stipulated in the tax treaties, starting points being:

- the date of the tax assessment letters
- the date of the withholding tax slips, or
- other times as stipulated by the DGT.

Furthermore, consultation with the treaty partner's tax authority should ideally be concluded within three years of initiating MAP (i.e. from the date where the initial consultation is conducted). If required however, an extension should be agreed by the two competent tax authorities once the three-year consultation period has passed.

Advance pricing agreements (APAs)

On 1 January 2001, the Indonesia Income Tax Law included a provision that authorised the DGT to enter into an APA, which is valid for agreed periods and is renegotiable. As is the case in many other countries, unilateral or bilateral APAs can be an advantageous way of resolving TP uncertainties before they become acrimonious disputes.

On 31 December 2010, the DGT released APA regulation PER 69. The Minister of Finance recently issued PMK-7 on 12 January 2015 regarding the formation and implementation of an APA. This regulation will be effective from 90 days after the enactment date (i.e. 12 April 2015) and applicable for all outstanding and future APA applications.

Under PMK-7, an APA application can be submitted by:

- an Indonesian taxpayer or a foreign taxpayer who has a permanent establishment in Indonesia, or
- a taxpayer of a treaty country or jurisdiction through their tax authority.

However, PMK-7 stipulates that an Indonesian taxpayer or a foreign taxpayer who has a PE in Indonesia, to enter the APA process, it must have been operating or conducting business activities in Indonesia for at least three years prior to entering the APA process.

In accordance with PMK-7, effectively a unilateral APA will be valid for a maximum of three years. However, in relation to bilateral APAs, the validity period can be extended to a maximum of four years.

It is clear in PMK-7 that an APA can only be entered into for future tax years. Taxpayers should not expect an APA to be 'rolled-back' to address any TP matters in open years in relation to the same/similar transactions. However, as noted in PMK-240, the DGT or the Competent Authority of the treaty partner can request a MAP, as a follow-up to an APA application, to settle any double taxation in accordance with a relevant treaty.

PMK-7 sets out the APA process into the following broad stages:

- Establishment of the APA which includes the following process:
  - Preliminary discussions
  - Invitation to file an APA application
  - APA application
  - Discussions on the APA

Formally PMK-7 also now requires the DGT to confirm whether or not a taxpayer can continue to the APA application stage. The timeframe and correspondence product for this confirmation are as follows:

- Completing the APA document.
- The implementation stage which includes the evaluation of the APA through an Annual Compliance Report (ACR) and the potential to submit a new APA application for subsequent years.

The stages are relevant for both unilateral and bilateral APAs. The pre-lodgement meeting request must now be submitted at least six months prior to the beginning of the tax year covered in the APA. As with PER-69, the pre-lodgement meeting does not bind the DGT or taxpayer to proceed to further stages.

- Where the DGT agrees to continue to the APA discussion stage, it will issue an invitation letter to the taxpayer no later than one month prior to the tax year that will be covered in the APA.
- Where the DGT declines to progress further, the DGT will issue a notification letter to the taxpayer no later than one month before the end of the tax year when the pre-lodgement meeting request was submitted.

The APA discussion stage should be undertaken within one year of the APA application. However, the DGT has acknowledged that in some cases an extension may be required. In relation to bilateral APAs, the APA discussions will be undertaken in accordance with the timeframe under the MAP proceedings.

Furthermore, PMK-7 specifically precludes the DGT from initiating an audit based on the information received during this process and is required to hand back all information received during this process if it does not allow the taxpayer to apply for an APA. However, PMK-7 also states that this does not preclude the DGT from initiating audit proceedings from within its normal right to audit.

Anticipated developments in law and practice
It is anticipated that further TP guidelines will be issued by the DGT in the near future in line with the recent developments in the OECD. It is also anticipated that the tax authorities will continue to conduct extensive TP audits over the next few years.

Liaison with customs' authorities
Liaison between income-tax authorities and customs' authorities are guided by a regulation issued by the MoF. This regulation provides that the joint audit is a tax audit activity, customs and/or excise that are performed jointly between the tax auditor, customs and excise auditor, appointed by the Joint Audit Committee, on the taxpayer. Joint audit should be performed in accordance to the tax audit standard and for customs and excise should be performed in accordance with the customs and excise audit standard, respectively.

Joint investigations
A regulation was issued by the MoF on 1 April 2014, which further facilitates the Exchange of Information (EOI) procedure. This MoF regulation stipulates that the EOI can be initiated by the relevant unit under the authority of the DGT or 'Unit' for domestic request or initiated by a country/jurisdiction partner for foreign request.

However, there is no specific regulation or guidance for joint investigation between Indonesia and country/jurisdiction partners.

Comparison with OECD Guidelines
The Indonesian TP regulations largely follow the principle sets out in the OECD Guidelines. For instance, the OECD Guidelines and the Indonesian TP regulations both endorse the arm's-length principle and prescribe the use of the five TP methodologies to determine the arm's-length nature of the controlled transactions.

The Indonesian TP regulations also consider the five comparability factors set out in the OECD Guidelines in preparing comparability analysis. The ITO continues to draw reference from the OECD Guidelines and continues to issue new regulations that assist taxpayers in complying with the arm's-length principle.

Indonesia

49.

Iraq

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Overview

Even though Iraq does not have specific transfer pricing (TP) legislation, the Income Tax Law contains a general anti-avoidance rule (GAAR). This GAAR allows the competent authority to adjust profits when transactions appear not consistent with the arm's-length principle.

The lack of specific TP guidance may expose any foreign investment into Iraq to a certain level of tax risk.

Country	**Iraq**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	No statutory TP documentation requirements
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes

Iraq

Country	Iraq
How are penalties calculated?	10% for non- or late submission of tax returns 10%–25% of the assessed income 5% to 10% for late payment

Introduction

Even though Iraq does not have specific TP legislation, the Income Tax Law contains a GAAR. This GAAR allows the competent authority to adjust profits when transactions appear not consistent with the arm's-length principle.

Legislation and guidance

Article 21 of the Income Tax Law states that if a non-resident undertakes a commercial enterprise with a resident and it appears to the Financial Authority that because of the special connection existing between the resident and the non-resident, and the substantial control of the one of them over the other, it is possible to arrange the business or it is actually so arranged to leave no profits to the resident, or the profits left are much less than what could normally be earned, then the tax shall be assessed on actual profits on the non-resident and they shall be charged for the tax in the name of the resident as if they were an agent for the non-resident for administering the business.

Where it appears to the Financial Authority that the actual amount of profits of a non-resident subject to tax in the name of a resident, cannot easily be determined, the Financial Authority, if they find it suitable, may assess the tax on the non-resident and make them subject to it at a fair and reasonable percentage of the turnover of the commercial business undertaken, by the non-resident through or with the resident. In such cases, the provisions of this Law relating to submission of returns and notifications by persons acting on behalf of others shall necessarily include submitting returns and notifications by the resident concerning the business done by the non-resident in the same manner followed by the persons acting for interdicted persons or non-resident persons. The percentage of profit shall, in each case be determined having regard to the nature of the business and shall, when determined by the Financial Authority, be subject to appeal as provided for in this Law.

Penalties

A penalty is imposed on the person making any contravention to the provisions of the Commercial Book-keeping Regulations for Income Tax Purposes at the rate of 10%–25% of the assessed income, before deducting legal allowances.

The competent authority will impose an additional amount at the rate of 10% of the tax, provided it does not exceed 500,000 Iraqi dinar (428 United States dollars) on the taxpayer who does not submit or refuses to submit an income tax return by 31 May of each year, or on whoever causes a delay to the completion of the assessment of their income, unless the taxpayer proves that the delay has been caused by a lawful excuse.

When assessed, a notice of assessment is sent to the corporation stating the amount of corporate income tax due. From that date (due date), the interest rate will be that charged by Al-Rafidan bank on overdraft facilities. If the tax is not paid within 21 days of the due date, an additional penalty of 5% of the tax due shall be imposed. If the tax due is not paid within this period, a penalty of 10% of the tax due will be imposed after an additional 21 days.

Documentation

There is no specific requirement to prepare a TP report. The company and its director are personally financially responsible to submit the accounts and necessary documents and all other matters required by the provisions of the Income Tax Law.

Transfer pricing controversy and dispute resolution

No specific regulations exist in this regard.

The taxpayer, after being notified of the assessed income and the tax payable thereon, may submit an objection in writing to the competent authority within 21 days from the date of notification, showing reasons for objection and the amendment demanded. The taxpayer shall submit to the competent authority such books, records and the necessary statements regarding their income as it may require in order to verify their objection.

The taxpayer, whose objection is rejected by the competent authority, may appeal against its decision to the Appeal Committee, by an application to be submitted to the Committee within 21 days from the date they are notified of the rejection of their objection.

The Cassation Panel may cancel, confirm or modify the decision of the Appeal Committee and its decision is final.

Comparison with OECD Guidelines

Notwithstanding the lack of clear guidance in the Iraqi tax regulations, the OECD Guidelines are generally accepted as the international best practice.

Iraq

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Ireland

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Overview

Irish transfer pricing (TP) legislation is effective for accounting periods beginning in 2011 and thereafter, and is thus still relatively new. However, multinationals in Ireland have long had regard to TP principles in establishing their related-party dealings due to the prevalence of TP rules in jurisdictions where affiliates were located.

In late 2012, the Irish tax authority introduced its Transfer Pricing Compliance Review (TPCR) Programme which will be used for the purpose of monitoring compliance with Irish TP legislation. In 2015, a dedicated TP audit team was formed within the Large Cases Division of the Irish tax authorities and begun to initiate specific TP audits. This TP unit is expected to take responsibility for the TPCR programme and all TP audits initiated by the Irish tax authorities.

Country	**Ireland**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	At time terms of transaction are agreed
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the adjustment

Ireland

Introduction

As part of the 2010 Finance Act, Ireland introduced broad-based TP legislation. The legislation endorses the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and adopts the arm's-length principle. The regime applies to domestic as well as international related-party arrangements and came into effect for accounting periods commencing on, or after, 1 January 2011, in relation to certain arrangements entered into on, or after, 1 July 2010.

Prior to the publication of this legislation, the TP provisions contained within the Irish tax legislation were previously only of limited application, and few resources were devoted to the issue by the Irish tax authorities. Despite the absence of local regulations and scrutiny prior to the 2010 Finance Act, transfer pricing was already a significant issue both for multinationals operating in Ireland and for Irish companies investing abroad because of the TP regulations in place in many overseas jurisdictions where the affiliates trading with Irish companies were located.

Legislation and guidance

Part 35A of transfer pricing legislation

Part 35A, section 835A to section 835H, of the 1997 Taxes Consolidation Act (Part 35A), contains Ireland's domestic law dealing with TP. Part 35A confers a power on the Irish tax authorities to recompute the taxable profit or loss of a taxpayer where income has been understated or expenditure has been overstated as a result of certain non-arm's-length arrangements. The adjustment will be made to the Irish taxable profits to reflect the arrangement, had it been entered into, by independent parties dealing at arm's length.

Ireland's TP rules apply to arrangements entered into between associated persons (companies) on, or after, 1 July 2010, involving the supply or acquisition of goods, services, money or intangible assets and relating to trading activities within the charge to Irish tax at the trading rate of 12.5%. However, an exemption from the rules is available for small- and medium-sized enterprises (SMEs).

Two unique characteristics

Interestingly, the legislation contains the following two unique characteristics:

- The regime is confined to related-party dealings that are taxable at Ireland's corporate tax rate of 12.5% (i.e. trading transactions). (Certain 'excepted trades' are taxed at Ireland's higher corporation tax rate of 25% and are subject to Irish TP rules. Excepted trades are limited to dealings in land other than construction activities, working with certain minerals and petroleum activities; section 21A of the Taxes Consolidation Act refers).
- A 'grandfather' clause whereby arrangements entered into between related parties prior to 1 July 2010 are excluded from the new TP rules.

Exclusion of non-trading activities

The TP regime is confined to related-party dealings that are typically taxable at Ireland's corporate tax rate of 12.5% (i.e. trading transactions). Activities that are deemed to be non-trading or 'passive' in nature and which are taxable at the higher rate of 25% will be excluded from the scope of the new regime.

Passive income for the purposes of the regime may include interest, royalties, dividends and rents from property where the income arising is not derived from an active trade. In practice, each transaction must be examined in the context of the company and its business to determine if it will constitute trading or passive income.

The question of whether a trade exists will initially be decided by the taxpayer, because the Irish tax system is based on the principle of self-assessment. The term 'trade' is defined in Irish tax legislation as including 'every trade, manufacture, adventure or concern in the nature of trade'. However, the legislation does not outline specific rules for distinguishing between trading and non-trading activities. Guidance as to what constitutes trading is available from case law and from a set of rules known as the 'Badges of Trade', which have been laid down by the courts in various cases over the years and which were set out in the 1954 report of the UK Royal Commission on Taxation. This report and the approach of the courts have been adopted into practice in Ireland to examine the specific facts of an individual case and look for the presence, or absence, of common features or characteristics of trade.

In addition to the available case law, it is possible for a taxpayer to make a submission to the Irish tax authorities to seek an advance ruling on whether trading activities are being carried out.

The distinction between whether a company's activities are deemed to be trading or passive in nature is therefore crucial for determining whether the related-party transactions will fall within the scope of the new regime. The determination will depend on the specific facts and circumstances of each case.

Grandfather clause

The other unique characteristic in the legislation is that the TP rules apply only to arrangements entered into on, or after, 1 July 2010. The term 'arrangement' is defined within the draft legislation as 'arrangements or agreements, whether or not legally enforceable or intended to be legally enforceable'. A guidance note from the Irish tax authorities in June 2010 states that an arrangement will qualify for this 'transitional treatment' if:

- the terms of the pre-1 July 2010 agreement clearly envisage the transaction, and
- the application of these terms delivers the price of the transaction.

The guidance note also states that an agreement to enter into a future agreement would not be considered to meet these conditions.

Other key features of the transfer pricing regime

Associated persons

Part 35A applies only to arrangements between associated persons. Two persons party to an arrangement will be considered associated if one person participates in the management, control or capital of the other person, or if a third person participates in the management, control or capital of each of the two persons, party to the arrangement. A person is deemed to be participating in the management, control or capital of another person if that other person is a company and is controlled by the first person.

Nature of related-party dealings
Part 35A applies only to related-party arrangements involving 'the supply and acquisition of goods, services, money or intangible assets'. It is noted that all these terms are commonly used in the OECD TP Guidelines, with the exception of the term 'money'. The OECD Guidelines instead use the terminology 'financial relations' (OECD Guidelines, Chapter I, 1-3).

Effective date
Part 35A came into effect for accounting periods commencing on, or after, 1 January 2011, in relation to any arrangement entered into on, or after, 1 July 2010. For example, a company with a 31 December year-end is subject to the TP rules for the year ended 31 December 2011 and any subsequent year, but only in relation to arrangements entered into on, or after, 1 July 2010.

Understatement of Irish profits
The regime is 'one way', facilitating an upwards adjustment to taxable profits where the profits of an Irish taxpayer are understated as a result of non-arm's-length TP practices. The regime confers a power on the Irish tax authorities to recompute the taxable profit or loss of a taxpayer where income has been understated or where expenditure has been overstated. The adjustment will be made to reflect arrangements that would be entered into by independent parties.

Exemption for small- and medium- sized enterprises
Part 35A contains an exemption from the TP rules for small-and medium-sized enterprises (SMEs). The definition of an SME is assessed at a group level and is based on the definition in the EU Commission Recommendation of 6 May 2003. In this regard, a group will be regarded as an SME, if it has:

- fewer than 250 employees, and
- either a turnover of less than 50 million euro (EUR) or assets of less than EUR 43 million.

This exemption is likely to have the effect of excluding a large number of domestic Irish companies from the TP regime.

Branches
Based on the definition of 'person' as defined in domestic Irish tax legislation, any arrangements entered into between a branch and its head office do not fall within the scope of the TP rules on the basis that a branch and head office cannot constitute two separate persons. However, a transaction between an Irish branch and a foreign affiliated company will fall within the scope of the rules on the basis that this will constitute a relationship between two separate persons.

Thin capitalisation
There are no specific thin capitalisation rules in Ireland, but some provisions in the Irish tax legislation can deny a full deduction for interest payments in certain circumstances.

Interest payments to overseas affiliates may, depending on the location of the recipients, be reclassified as distributions in certain situations, and therefore would not be tax-deductible.

Other provisions apply to deny an interest deduction in circumstances where borrowings from a related party are used to acquire share capital from (or lend to) a company that immediately before the loan was connected with the borrower.

The reader is urged to consult with an Irish tax adviser concerning the application of the deemed distribution and restriction on deductibility of interest rules.

Management services

The TP rules apply to the provision of management services where those services represent an arrangement for the purposes of Part 35A as described previously. Where an Irish company is paying for management services, the general rules on deductible expenses will apply. Generally, this means that a payment will be deductible for tax purposes where a company receives a benefit from the management services provided, once the payment is connected with the company's trade and was at an arm's-length price.

When a company is providing services, it should be remunerated for those services on an arm's-length basis and be seen to be generating income from the services provided to ensure a tax deduction is obtained for the costs it incurs in providing the services. This would usually be achieved by adding a profit element or mark-up to the cost of providing the services.

Summary

The following is a summary of the conditions that need to be met for the Irish TP rules to apply to an arrangement:

- The taxpayer does not qualify as an SME.
- The arrangement involves the supply or acquisition of goods, services, money or intangible assets.
- At the time of the supply, the supplier and the acquirer are associated.
- The profits, gains or losses arising from the relevant activities are within the charge to Irish tax under Case I or Case II of Schedule D (that is, trading transactions within the charge to tax at the 12.5% trading rate).
- The consideration payable or receivable under the arrangement is not at arm's length and results in an understatement of Irish profits.
- The terms of the arrangement were agreed on, or after, 1 July 2010.

Other regulations

Prior to the introduction of the TP regime, domestic TP provisions in Irish tax legislation, with one exception, were specific to particular types of transactions or to particular categories of taxpayer. A brief summary of these limited provisions is set out as follows.

Section 1036

One other general TP provision is contained in section 1036, Taxes Consolidation Act 1997. This section applies where, for example, an Irish company carries on business with an overseas' affiliate and, through the control exercised over the Irish company, the Irish company produces either no profits or less than the ordinary profits that might be expected to arise. In these circumstances, the overseas' affiliate will be chargeable for Irish income tax in the name of the Irish company, as if it were an agent of the Irish company.

Although a broad-based section, Section 1036 is not supported by any guidance from the Irish tax authorities on the application of the legislation, and definitions are not provided for key terms such as 'close connection and substantial control', included in the section. Further, the section focuses on whether the profits realised by an Irish company are commensurate with the ordinary profits expected, rather than whether the prices for the international related-party transactions entered into by the Irish company are at arm's length. Owing to these uncertainties, it is not believed that this section is applied in practice.

Companies engaged in businesses qualifying for incentive tax rates
Among the more limited TP provisions which had been enacted were those applying to Irish companies qualifying for Ireland's incentive tax rate of 10%. The 10% incentive tax rate dates to the early 1980s and was known as 'manufacturing relief'. The relief expired on 31 December 2010, and the introduction of a specific TP regime in Ireland was timed to coincide with the expiration of manufacturing relief.

Value added tax (VAT) and transfer pricing
On 2 April 2007, the Irish government enacted anti-avoidance legislation in relation to transactions between connected persons. This legislation gives the Irish tax authorities the power to impute an open-market value to the amount on which VAT is chargeable on a supply of goods or services. The legislation is a transposition of Article 80 of EU Council Directive No. 2006/112/EC, an EC Directive that member states were not necessarily obliged to enact locally.

Other domestic transfer pricing provisions
Other anti-avoidance provisions have been enacted for:

- the transfer of land between connected persons
- the charge to capital gains tax on the sale of assets to connected persons, and
- the transfer of trading stock to a connected person at the time a trade is discontinued.

In the last point, the provisions apply where the payer and beneficial recipient are connected, stating that the exemption will apply only to as much of the payment as would have been made by an independent person acting at arm's length.

Penalties
Part 35A does not contain any specific penalty provisions with respect to a TP adjustment. In the absence of specific penalty provisions being included, the Irish tax authorities have indicated that the general corporate tax penalty provisions and the Code of Practice for Revenue Audit will apply to assessments raised, due to TP adjustments under the new TP rules. The Finance (No.2) Act 2008 formally introduced Ireland's tax geared penalty system with the new penalty regime applying to cases of tax default occurring on, or after, 24 December 2008.

Under the general corporate tax penalty provisions, interest arises on underpaid tax at a daily rate of 0.0219%, which is 7.99% per annum.

Also in their Code of Practice, the Irish tax authorities have set out a 'penalty' grid, which shows the penalties charged for each of three categories of default on the part of the taxpayer. The tax-geared penalty is a percentage of the underpaid tax. The least

serious category of default is 'careless behaviour without significant consequences' (with a 20% penalty), and the most serious is 'deliberate behaviour' (with a 100% penalty). The grid also shows that the penalty level can be reduced where the taxpayer cooperates during the audit with the Irish tax authorities. (Essentially, this means that the taxpayer complies with all reasonable requests made by the Irish tax authorities for records and assistance.) The grid is reproduced here:

No Qualifying Disclosure	Category of Default	No Co-operation	Co-operation only
All defaults where there is no qualifying disclosure	Careless behaviour without significant consequences	20%	15%
	Careless behaviour with significant consequences	40%	30%
	Deliberate behaviour	100%	75%

An additional penalty grid is provided which shows how the level of penalty can be reduced based on the type of any qualifying disclosure made by the taxpayer and whether or not previous qualifying disclosures were made within the previous five years. Certain conditions are required to be met in order for a disclosure to be a qualifying disclosure. The two types of qualifying disclosure are:

- a prompted qualifying disclosure, where the qualifying disclosure is made as a consequence of a notification letter received from the Irish tax authorities advising that the taxpayer has been selected for audit, and the disclosure is made between the date of notification of the audit and the date the audit starts, or
- an unprompted qualifying disclosure, where the qualifying disclosure is made before any notification of audit is received from the Irish tax authorities and before any Revenue investigation commences.

The additional grid is reproduced here:

Penalty Table 1	Category of Default	Qualifying Disclosure	On or after 24/12/2008
All defaults where there is a qualifying disclosure		Prompted qualifying disclosure and co-operation	Unprompted qualifying disclosure and cooperation
All qualifying disclosures in this category	Careless behaviour without significant consequences	10%	3%
First qualifying disclosure in these categories	Careless behaviour with significant consequences Deliberate behaviour	20% 50%	5% 10%
Second qualifying disclosure in these categories	Careless behaviour with significant consequences Deliberate behaviour	30% 75%	20% 55%
Third or subsequent qualifying disclosure in these categories	Careless behaviour with significant consequences Deliberate behaviour	40% 100%	40% 100%

A separate penalty table applies where the tax default took place prior to 24 December 2008.

It remains to be seen how the Irish tax authorities will apply the Code of Practice to TP cases. The authorities have clarified in Tax Briefing Issue 07 of 2010 that “the quality of the supporting documentation will be a key factor in determining whether the adjustment should be regarded as correcting an innocent error or as being a technical adjustment”.

Documentation

Part 35A states that companies will need to provide documentation ‘as may reasonably be required’ and that documentation will need to be prepared ‘on a timely basis’. The Irish tax authorities issued further guidance (Tax Briefing Issue 07 of 2010) on the documentation that is required to be prepared by taxpayers to be compliant with the TP rules.

The guidance note supports the legislative basis and indicates that a company is required to have TP documentation available for inspection if requested by the Irish tax authorities.

Reference is made to the fact that the purpose of the documentation should be to demonstrate compliance with the TP rules. The Irish tax authorities have stated that the form and manner that the documentation takes ‘will be dictated by the facts and circumstances of the transactions’ and recognise that the cost involved in preparing the documentation should be ‘commensurate with the risk involved’. As an example, the guidance note states that the Irish tax authorities would expect complex transactions to have more detailed documentation in place in comparison with simple transactions.

Notably, the guidance note states that ‘it is best practice that the documentation is prepared at the time the terms of the transaction are agreed’. Additionally, the guidance note states that ‘for a company to be in a position to make a correct and complete Tax Return’, appropriate TP documentation should exist at the time the tax return is filed. It is worth noting that the taxpayer can maintain documentation in a form ‘of its own choosing’. Additionally, where documentation exists in another territory which supports the Irish arrangement, this will also be sufficient from an Irish TP perspective, on the basis that the documentation is in English. The Irish tax authorities have also confirmed that they will accept documentation that has been prepared in accordance with either the OECD TP Guidelines or the Code of Conduct adopted by the EU Council under the title ‘EU Transfer Pricing Documentation’.

The Irish tax authorities have set out a comprehensive list of information that must be included in the documentation that is prepared. The ‘documentation must clearly identify’:

- associated persons for the purposes of the legislation
- the nature and terms of transactions within the scope of the legislation
- the method or methods by which the pricing of transactions was arrived at including any benchmarking study of comparable data and any functional analysis performed
- how that method has resulted in arm’s-length pricing or where it has not, what adjustments were made and how the adjustment has been calculated

- any budgets, forecasts or other papers containing information relied on in arriving at arm's-length terms, etc., or in calculating any adjustment, and
- the terms of relevant transactions with both third parties and associates.

The Irish tax authorities have confirmed that TP documentation must be available for relevant arrangements 'that take place in accounting periods beginning on or after 1 January 2011'. The Irish tax authorities have also confirmed that documentation requirements will not apply to so-called grandfathered arrangements, the terms of which were agreed before 1 July 2010. The guidance note states that an arrangement will qualify for this 'transitional treatment' if:

- the terms of the pre-1 July 2010 agreement clearly envisage the transaction, and
- the application of these terms delivers the price of the transaction.

Transfer pricing controversy and dispute resolution

Burden of proof

Under Ireland's self-assessment system, the burden of proof in the event of an audit by the Irish tax authorities will fall on the taxpayer.

Transfer pricing compliance review

In 2012, the Irish tax authorities released details of a new Transfer Pricing Compliance Review (TPCR) programme under which they will monitor the degree of compliance with Irish TP rules.

Ebrief No 62/2012 issued on 26 November 2012 sets out the tax authority's approach to monitoring compliance with Irish TP rules contained in Part 35A.

Request to perform self-review

Companies that are selected for this programme will be contacted by an authorised officer of the tax authority, and provided with a notification to undergo a self-review of their compliance with the Irish TP rules. Companies selected will be requested to provide a report within three months to the tax authority in this regard.

The self-review to be documented in the report will cover a specific accounting period and will need to incorporate:

- the group structure of the multinational
- details of related-party transactions entered into by the Irish entity, specifying the type of the transaction(s) and the associated companies involved
- the pricing policy and the TP methodology for each type of related-party dealing
- the functions, assets and risks of the parties to the transactions
- a listing of the documentation available and reviewed in the context of the self-review, and
- the basis for establishing that the arm's-length standard has been satisfied.

Minimising the compliance burden

It is important to note that in order to minimise compliance costs, the tax authority have explicitly stated that existing studies elsewhere in the multinational group that cover the related-party dealings of the Irish operations will be sufficient, provided they contain the information set out above.

Selection of companies for TPCR
It is understood that companies will be selected from across a broad range of industries. There is no indication of the tax authority focusing on a particular type of related-party dealing or a particular industry segment.

The outcome of the TPCR process
The outcome of the TPCR for the company selected as part of the programme will be a post-review letter from the tax authority. This letter will either:

- state that the tax authority have no further enquiries on the self-review performed by the company, or
- list issues for further consideration or discussion that will also be addressed within the TPCR process.

TPCR is not a tax audit
It has also been clarified by the tax authority that the TPCR programmes are not tax audits covered by the 'Code of Practice' for their audits and investigations.

The practical implication of this clarification for companies selected for the TPCR is that a voluntary disclosure may be made to the tax authority at any time during the TPCR process, even after a company receives a post-review letter specifying issues for further consideration.

Possible escalation to a tax audit
In some instances, however, a case selected for TPCR may be escalated to an audit, based on the tax authority's risk assessment. Examples of where a TPCR may be escalated to an audit are stated as including instances where a company declines to complete a self-review or where the output from the review and any follow-up queries indicate that the company's TP policies may not be in accordance with the arm's-length standard. Should a case escalate from a TPCR to an audit, the company will be issued with a separate audit notification letter.

Tax audit procedures
Selection of companies for audit
Notwithstanding the TPCR programme, legislation permits the Irish tax authorities to carry out an inspection of tax returns filed under self-assessment, outside of this programme. The purpose of such an inspection is to satisfy the Irish tax authorities that a return is complete and accurate.

The Irish tax authorities are not obliged to disclose why they have picked a particular company or tax return for inspection. However, the selection of a return for inspection does not mean that the Irish tax authorities have evidence that tax has been underpaid. In many cases, the return is selected for audit for straightforward reasons, such as the level of turnover or profits generated by the company or the industry sector in which the company operates.

In the past, it would have been unusual for the Irish tax authorities to audit an Irish taxpayer for the sole reason of reviewing the arm's-length nature of its international related-party dealings. Rather, TP issues have been considered as part of a general corporation tax audit. However, with the introduction of Part 35A and the more recent formation of the TP audit team within the Large Cases Division of the Irish tax

authorities, the Irish tax authorities have built upon the TPCR programme and in 2015 began to initiate specific TP audits.

The annual corporation tax return form does not require an Irish company to disclose details to the Irish tax authorities on the type and value of the international related-party dealings entered into by the taxpayer.

The provision of information and the duty of the taxpayer to cooperate

Auditors of the Irish tax authorities are fully entitled to inspect any original record of transactions conducted in the period under audit, which is relevant to the company's tax position, or any document that links an original record to the company's finalised financial statements. Recent legislation has significantly widened auditors' inspection powers. An auditor is now entitled to inspect any document that relates to the company's business, not just records the company is obliged to maintain for tax purposes.

Part 35A states that only authorised officers, designated in writing by the Irish tax authorities, may make enquiries in relation to TP. The Irish tax authorities have to date limited the designation of authorised officers to a number of inspectors within the Large Cases Division of the Irish tax authorities but it is expected that the newly formed TP audit unit within the Large Cases Division will now account for most contact with taxpayers on TP matters.

The audit procedure

The Irish tax authorities will conduct a tax audit under the terms of the Taxpayers' Charter of Rights. Under the Charter, the Irish tax authorities are obliged to approach the audit on the assumption that the company is fully tax-compliant and its returns are correct. Prior to commencing the audit, the auditor can be expected to have carried out a detailed review of the company's tax files under all tax heads. The auditor will also have conducted a review of any information contained within the Irish tax authorities regarding the company's industry sector.

Also relevant to the audit procedure in Ireland is the Irish tax authorities' Code of Practice for Tax Audits, which sets out the procedures to be followed by the Irish tax authorities in their conduct of an audit and in reaching a settlement with the taxpayer. In notifying the company of their intention to undertake an audit of the company's tax affairs, the Irish tax authorities give the company until a specified date to decide whether it needs additional time to prepare a written disclosure of any negligent underpayments of tax. In the context of an audit by the Irish tax authorities, a disclosure states the amounts of any tax liabilities previously undisclosed for the tax heads or periods within the scope of the audit enquiry, together with the company's calculation of the associated interest and penalties arising from the undisclosed liabilities. The disclosure must be accompanied by payment of the total liability arising in respect of tax, interest and penalties. (Details on the calculation of interest and penalties are set out under the *Additional tax and penalties section*).

Audits generally commence with an opening meeting between the company and the official(s) of the Irish tax authorities carrying out the audit. In the situation where the taxpayer decides to make a written or verbal disclosure in relation to the returns under review, this will be presented to the auditor at the opening meeting. The auditor may ask for more information concerning the disclosure.

The initial audit work is likely to be devoted to checking the accuracy of any disclosure made by the taxpayer following notification of the tax audit. The auditor will then commence the inspection of the books and records supporting the tax return being audited.

Revised assessments and the appeals procedure
Following an audit, the Irish tax authorities may make an assessment where they are dissatisfied with a return or returns made by the company. Generally, a time limit of four years applies to the making of assessments where a full return has been made.

Where a taxpayer is dissatisfied with an assessment raised by the Irish tax authorities, the taxpayer has the right to appeal against the assessment. This appeal must be in writing and be made within 30 days of the issue of the assessment. The appeal can be resolved by an agreement reached with the Irish tax authorities or by means of a hearing in front of the Appeal Commissioners.

Depending on the decision of the Appeal Commissioners, the taxpayer may have further avenues to appeal for a rehearing to the Circuit Court, or to the High Court or Supreme Court on a point of law.

Resources available to the tax authorities
As mentioned above, the Irish tax authorities have in 2015 formed a dedicated TP audit unit within the Large Cases Division of the Irish tax authorities. This TP unit is expected to take responsibility for the TPCR programme and all TP audits initiated by the Irish tax authorities.

Use and availability of comparable information
Should an Irish company not have internal comparable data to support the arm's-length nature of its international related-party transactions, it may be able to obtain data on the gross and net margins of comparable companies operating in Ireland by acquiring the annual returns of relevant companies from the Companies Registration Office.

All companies registered in Ireland are obliged to file an annual return with the Companies Registration Office, unless an exemption from filing applies. Depending on the size of the company, financial statements may be required to be filed with the annual return.

Risk transactions and industries
There are not considered to be particular related-party transactions or industry sectors that could be regarded as facing a higher-than-normal risk of a TP enquiry from the Irish tax authorities.

To some extent, Irish taxpayers could be considered (indirectly) to be at a higher risk of a TP review should overseas tax authorities, which have developed extensive TP regulations, focus their attention on transactions or industries that include overseas affiliates of an Irish taxpayer.

Liaison with customs authorities

It is understood that there is no liaison between the income tax authorities and the customs authorities, even though they are both under the same Board of Management and are controlled by the Minister for Finance. Nevertheless, there is a significant overlap between the methods applied by the Customs Service to value a transaction between related parties and the methods contained in the OECD Guidelines to assess compliance with the arm's-length principle. Companies also must take care to ensure that any TP policies implemented are also appropriate from a customs perspective and vice versa.

Joint investigations

Under the terms of Ireland's tax treaties and the EU Mutual Assistance Directive, the Irish tax authorities can and do exchange information with treaty partners and fellow EU Member States. Generally, Ireland's tax treaties also allow for communication between Ireland and the treaty partners for the purposes of implementing the provisions of the double tax treaty (DTT).

Legal cases

Although Ireland's TP legislation is effective only for accounting periods commencing on, or after, 1 January 2011, the decision of the Irish High Court in the case of Belville Holdings Limited v Cronin in 1985 suggests that the Irish courts have been willing in the past to impose arm's-length pricing in transactions between related parties. The transaction considered in this case was the provision of management and other head-office services by Belville Holdings Limited, an Irish company, to its Irish resident subsidiary companies. As well as holding shares in subsidiaries, Belville Holdings Limited carried on a trade of managing its subsidiaries and providing finance to them. For all periods up to the year ended 30 October 1978, the total expenses incurred by Belville Holdings Limited were apportioned among the subsidiaries and recharged to them. This company policy changed with effect from the period commencing 1 November 1978, whereby only the operating expenses directly incurred for the benefit of the subsidiaries were recharged; other expenses not specifically allowable to the subsidiaries were borne by Belville Holdings Limited. This had the effect of trading losses being incurred by Belville Holdings Limited following the change of policy.

The case focused on two accounting periods, the period ended 30 June 1979, and the year ended 30 June 1980, in which Belville Holdings Limited and all but two of its subsidiaries realised trading losses. Belville Holdings Limited did not receive management fees from its subsidiaries in these periods. However, the two profitable subsidiaries paid over their entire profits in each period to Belville Holdings Limited as dividends. Under tax legislation in force at the time, Belville Holdings Limited, by virtue of the trading loss it incurred in each period, claimed a repayment of the tax credits attaching to the dividends received from its two subsidiaries.

The Inspector of Taxes rejected the repayment claim of Belville Holdings Limited. The Irish tax authorities took the view that the losses of Belville Holdings Limited were not genuine trading losses, on the basis that Belville Holdings Limited had arranged its policy for recharging its management expenses to facilitate the claim for repayment of the tax credits. This position was upheld in the Appeal Court, which relied on the UK case of Petrotim Securities Limited v Ayres (1963) in stating that notional management fees equivalent to the market value of the services provided by Belville Holdings Limited should be included as assessable income of Belville Holdings Limited.

On appeal by Belville Holdings Limited to the High Court, the judge upheld the position of the Appeal Commissioners that notional management fees should be included in the tax computation of Belville Holdings Limited. However, the High Court also found that there was no evidence to uphold the Appeal Commissioner's arbitrary estimation of the market value of the services provided, which was set at 10% of the income of each of the two subsidiaries. For this reason, the High Court upheld the appeal of Belville Holdings Limited, but crucially did not refer the matter back to the Appeal Commissioners to reconsider a more appropriate valuation of the notional management fees.

The issue later arose as to whether the High Court division in Belville Holdings Limited had definitively found in favour of the taxpayer or whether the High Court intended to refer the matter back to the Appeal Commissioners. A Supreme Court hearing found that the High Court decision could be interpreted only as being in favour of Belville Holdings Limited.

In conclusion, although the Irish courts never ruled on an appropriate market value for the notional management fees, the case of Belville Holdings Limited v Cronin indicates that the Irish courts may support the Irish tax authorities in applying arm's-length pricing for transactions between connected persons. No other such cases have come before the Irish courts since 1985, and it is doubtful whether the Belville Holdings case could be solely relied upon in consideration of transactions between an Irish company and an international related party prior to the effective date of the new TP rules.

Limitation of double taxation and competent authority proceedings
To date, Irish companies normally contemplate competent authority proceedings in respect of TP adjustments imposed by overseas' tax authorities on international related parties that trade with the Irish companies, but in future proceedings are likely to also arise from TP adjustments imposed by the Irish tax authorities.

Currently all of Ireland's tax treaties contain a mutual agreement procedure. The Irish tax authorities are willing to support requests for competent authority relief on application by Irish taxpayers, subject to the facts and circumstances of the cases coming within the provisions of the relevant DTT.

It should also be noted that as a member of the European Union, Ireland is bound by the Code of Conduct to eliminate double taxation in the area of TP, approved by the EU Council of Finance and Economic Ministers on 7 December 2004. The Code of Conduct aims to ensure more effective and uniform application by EU Member States of the 1990 Arbitration Convention (90/436/EEC), which was designed to deal with double taxation issues faced by taxpayers arising from TP adjustments.

Advance pricing agreements (APA)
Ireland does not have a formal APA procedure for Irish companies to agree prices with the Irish tax authorities for international related-party transactions. However, the Irish tax authorities have been willing to negotiate and conclude bilateral APAs with treaty partners, and they are generally willing to consider entering such negotiations once a case has been successfully accepted into the APA programme of the other jurisdiction. It remains to be seen whether Ireland will formalise its APA procedures in light of the recent introduction of the new TP rules.

It should also be noted that the Irish tax authorities have, upon request, provided inward investors with advance rulings on key tax issues relevant to the decision to establish operations in Ireland. Until recently, these advance rulings were generally provided on a company's qualification for Ireland's manufacturing relief. Of late, the key tax issue upon which taxpayers are requesting advance rulings from the Irish tax authorities is whether income from a particular activity would be regarded as trading income (taxed at 12.5%) or passive income (taxed at 25%).

Comparison with OECD Guidelines

Ireland is a member of the OECD, and the Irish tax authorities have publicly recognised that the OECD Guidelines are the internationally accepted standard for the allocation of profits among entities of a multinational. Irish TP rules endorse the OECD Guidelines, and Part 35A should be construed in a manner that best ensures consistency with the OECD Guidelines.

Ireland

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Israel

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Overview

The Israeli transfer pricing (TP) regulations (the Israeli TP Rules) promulgated under sections 85A, 243 and 244(A) of the Israeli Tax Ordinance (ITO) generally follow the Organisation for Economic Co-operation and Development (OECD) Guidelines as well as section 482 of the US Internal Revenue Code. The Israeli TP Rules require that all cross-border transactions carried out between related parties be consistent with the arm's-length principle and are expected to be taxed accordingly. Upon approval by the tax assessing officer (AO) granted to a taxpayer, certain one-time transactions may be excluded from the scope of the regulations.

According to section 85A of the ITO, the Israeli TP Rules apply substantially to all types of cross-border transactions in which a special relationship exists between the parties to the transaction. Special relationship includes the association between an individual and their relative, the control of one party to the transaction over the other or the control of one individual over the other parties to the transaction, whether directly or indirectly, singly or jointly with other individuals. These transactions including various types of services (such as research and development, manufacturing, marketing, sales and distribution), the use or transfer of tangible and intangible goods and financing transactions, are required to be carried out according to the arm's-length principle.

Country	**Israel**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No

Israel

Country	Israel
When must TP documentation be prepared?	A taxpayer engaged in a cross-border controlled transaction(s) is required to include in its annual tax return an annual declaration (form #1385) describing the transaction(s) and its nature including references to its price and other relevant terms and conditions. In addition, the Israeli Tax Authority (ITA) is entitled to demand full TP documentation within 60 days of such request.
Must TP documentation be prepared in the official/local language?	Generally it is required to prepare the TP documentation in Hebrew or Arabic. However, TP documentation in English is accepted.
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	No specific TP penalties exist under the Israeli TP Rules. However, general penal and monetary sanctions set in the Israeli tax legislation may apply – interest rate and linkage to consumer price index also apply to tax amount due.

Introduction

On 24 July 2002, the Israeli Parliament completed comprehensive tax reform legislation, which came into effect 1 January 2003. The reform includes TP provisions that require all cross-border inter-company transactions to be carried out at arm's-length terms. The enacted sections 85A, 243 and 244(A) incorporate the arm's-length principle, which applies to any international transaction in which there is a special relationship between the parties of the transaction, and a price was settled for property, a right, a service or credit. Sections 85A, 243 and 244(A) came into effect upon issuance of final TP regulations by the Israeli Parliament on 29 November 2006.

Legislation and guidance

A cross-border controlled transaction is considered to be arm's length if, following the comparison to similar transactions, the result obtained does not deviate from the results of either the full range of values derived from comparable uncontrolled transactions when the comparable uncontrolled price (CUP) method is applied (under the assumption that no comparability adjustments were performed) or the interquartile range (the values found between the 25th and 75th percentiles in the

range of values) when applying other methods. Under a TP audit, if the results of the cross-border controlled transaction fall outside the relevant range (either the full range or the interquartile range, depending on the method used), the transfer price will be set at the median of the comparable results.

Application of the arm's-length principle is generally based on a comparison of the conditions in a cross-border controlled transaction with the conditions surrounding similar transactions entered between independent companies (comparable companies). To determine if a cross-border controlled transaction has been carried out in accordance with the arm's-length principle, the following steps need to be taken:

- Identify the cross-border controlled transactions within the group.
- Identify the tested party for each respective transaction.
- Perform a functional analysis with special emphasis on comparability factors such as business activity, the characteristic of property or service, the contractual conditions of the cross-border transaction and the economic circumstances in which the taxpayer operates.
- Select the appropriate TP method(s).
- Select the comparable companies and establish an arm's-length range, determined by the comparable companies.
- Examine whether the tested party's results fall within the arm's-length range.

Transfer pricing methods

In general, the Israeli TP Rules specify the following TP methods, which would need to be applied in hierarchical order as further described below:

- CUP method – a method that compares the prices for property or services transferred or provided in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction under comparable circumstances. If the CUP method cannot be applied, then one of the following methods, which is most appropriate according to the specific circumstances, should be applied:
- Profitability method – a method that compares the profitability that a taxpayer realises from a controlled transaction to profit margins in comparable uncontrolled transactions:
  - Cost plus (CP) method – a method that compares markup on direct costs.
  - Resale price method (RPM) – a method that compares the gross profit margins.
- If the CP or RPM cannot be applied, then the comparable profit method (CPM) should be applied. The CPM compares profitability according to profit level indicators (PLIs), which are most appropriate according to the specific circumstances, as determined in the Israeli TP Rules.
- Profit split method (PSM) – a method that compares the controlled transaction with an uncontrolled transaction according to the division of profits or losses between related parties, which reflects the contribution of each party to the transaction including the exposure to risks and rights to the assets relating to the transaction.
- Other methods – in cases where none of the above-mentioned methods can be used to derive the most reliable measure of an arm's-length result, the taxpayer may apply any other method as the most appropriate method under the specific circumstances.

Under the Israeli TP Rules, there is no specific requirement that the tested party's geographic market be the same as that of the comparable companies. In practice, comparables in the same geographic market as the tested party are preferred because they are thought to be of better comparability.

Penalties

No specific TP penalties exist under the Israeli TP Rules. However, general penal and monetary sanctions set in Israeli tax legislation may apply.

Documentation

Under the Israeli TP Rules, there is no stated requirement as to documentation needing to be contemporaneous with the company's tax filings. However, a taxpayer engaged in a cross-border controlled transaction is required to include in its annual tax return a special form (#1385) describing the transaction and its nature including references to its price and other relevant terms and conditions (*see further discussion below*). In addition, the tax AO may issue the taxpayer a formal letter of request, requiring the taxpayer to submit, within 60 days, all relevant documentation and other information related to the inter-company transaction.

Reporting procedures

The Israeli TP Rules require all taxpayers engaging in cross-border controlled transactions to include in their annual tax return the 'Declaration of International Transactions' form (#1385). The form must be filled out for each and every cross-border transaction between related parties and attached to the annual income tax return. This form applies as from the 2007 tax year and has been updated during 2010. The TP form contains the following details:

- Transaction number – a separate form must be filled out for each and every cross-border transaction with each related party.
- Transaction description – the field of activity must be specified, such as: manufacturing, marketing, sales, distribution, research and development, consulting and provision of services. Furthermore, in cases of buying and selling of goods or provision/receipt of services, the type of asset or service must be specified.
- Details of the related party involved in the transaction – the name of the related party involved in the transaction must be specified in addition to the related-party's location and registration number abroad, as documented in its incorporation documents.
- The total price of the transaction – the selected TP method must be specified in addition to the total consideration regarding the inter-company transaction between the related parties.

The taxpayer is required to attach to the annual tax return the signed TP form, stating that 'I hereby declare that the transaction with foreign related parties is in accordance with the arm's-length principle, as defined in Sections 85A of the Israeli Tax Ordinance and the relating regulations' (free translation from Hebrew).

Full documentation report

According to the Israeli TP rules, as mentioned, the tax AO may issue the taxpayer a formal letter of request, requiring the taxpayer to submit, within 60 days of the latter's request, all relevant documentation and other information related to the inter-company transactions.

This information includes, among others:

- Description of the principle inter-company transactions and the parties involved in these transactions.
- Description of the business environment and the economic circumstances in which the parties operate.
- Functional analysis of the parties involved in the inter-company transactions (including functions performed, risks assumed and resources employed).
- Selection of the pricing method(s) and the reasons behind such selection.
- Economic analysis (determination of arm's-length prices).
- The conclusions that may be derived from the comparison to uncontrolled comparable companies.

In addition, the taxpayer should submit supporting documentation such as contracts; any disclosure made regarding the controlled transactions to any foreign tax authority including any request for an advanced pricing agreement (APA); and any differences between the prices reported to the foreign tax authority and the prices reported in the Israeli tax returns. Furthermore, the taxpayer is required to disclose all TP studies conducted or an assessment prepared for purposes of filing to the Israeli or other foreign tax jurisdictions, as well as any opinion from an accountant or lawyer, if such were given.

Statute of Limitations

Three years from the end of tax year in which the relevant tax return is filed (with the commissioner's approval – within four years after the end of the said tax year). These periods may be subject to extensions where fraudulent circumstances exist.

Transfer pricing controversy and dispute resolution

Advanced pricing agreements (APA)

A taxpayer that is a party to a cross-border controlled transaction may request an APA from the ITA for a particular transaction or for a series of transactions that have been set at arm's-length levels. The request for such an agreement should include supporting documentation with respect to the transaction including documents that demonstrate how the transfer price was established, inter-company agreements, and opinions or any other supporting documentation that supports the arm's-length compensation that has been established for the specific transaction.

The ITA will inform the taxpayer of their decision within 120 days (this period can be extended to 180 days). If the ITA does not respond during this period, the transfer price will be deemed to have been set at arm's-length levels.

Currently, the ITA issue only unilateral APAs. At the conclusion of the APA procedure, there is a binding agreement between the taxpayer and the ITA.

Burden of proof

According to the Israeli TP Rules, the initial burden of proof lies with the taxpayer. The taxpayer is required to submit the appropriate documentation and relevant information of the inter-company transactions to the tax AO within 60 days of the latter's request. Once the taxpayer has presented all relevant information as required, the burden of proof shifts to the AO.

Comparison with OECD Guidelines

As mentioned, the Israeli TP Rules generally follow the OECD Guidelines. The three main divergences from the OECD Guidelines are the following:

- As discussed above, the TP methods specified in the Israeli TP Rules need to be applied in a specific hierarchical order.
- As discussed above, according to the Israeli TP Rules, a cross-border controlled transaction is considered to be arm's length if, following the comparison to similar transactions, the result obtained does not deviate from the results of either the 'full' range of values derived from comparable uncontrolled transactions when the CUP method is applied (under the assumption that no comparability adjustments were performed) 'or the interquartile' range when applying other methods. If the results of the cross-border controlled transaction fall outside the relevant range (either the full range or the interquartile range, depending on the method used), the transfer price will be set at the median of the comparable results.
- According to the Israeli TP rules comparable companies' financial data can be used for no more than three years prior to the tested year.

52.

Italy

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Overview

The arm's-length principle applicable to inter-company transactions under the Organisation for Economic Co-operation and Development (OECD) Guidelines is contained in the concept of 'normal value' included in the Italian Income Tax Code (Article 9 paragraphs 3 and 4, and Article 110, paragraph 7, of Presidential Decree no. 917 dated 22 December 1986).

Guidelines on transfer pricing (TP), which were based on the 1979 OECD Report are still extant in the Circular Letter issued by the Ministry of Finance dated 22 September 1980 No. 32/9/2267, although subsequent versions of the OECD Guidelines, particularly those issued in 2010 are used as a point of reference. An optional documentation regime, which allows penalty protection in relation to TP adjustments, was introduced by Article 26 of Law Decree No. 78 of 31 May 31 2010.

The Regulation dated 29 September 2010 established TP documentation requirements based on the concept of master file and country file, according to the EU Code of Conduct for Transfer Pricing Documentation. If the specific requirements described in the Regulation are followed (e.g. documentation to be prepared in Italian language, the specific form provided by the Regulation is mandatory, etc.) and the tax authorities also accept the substance of the documentation as adequate, taxpayers benefit from penalty protection in the event of TP adjustments. Taxpayers have to declare in the annual tax return that they possess TP documentation in order to benefit from the penalty protection regime.

All OECD methods are accepted by the Italian Tax Authority (ITA), although the comparable uncontrolled price (CUP) method and the two other traditional transaction-based methods are preferred where available.

According to Article 8 of Law Decree No. 269 of 30 September 2003, taxpayers may apply for an 'International Tax Ruling', which is a unilateral advance pricing agreement (APA). It is possible to obtain bilateral and multilateral APAs where a double taxation agreement (DTA) exists between Italy and the state of the counterparty based on Article 25, paragraph 3 of the OECD Model Convention. Unilateral APAs have effect from the year in which the agreement is reached and for the four subsequent fiscal years. This procedure can now also cover the issue of the existence or otherwise of a permanent establishment (PE) in Italy, not just attributable profit.

Italy

Country	Italy
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	By the tax return filing deadline
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Percentage of tax assessed

Introduction

Transfer pricing has gained increasing attention in recent years in Italy. This was due to an ongoing relocation of manufacturing out of Italy to territories with low production costs, developed infrastructure, tax incentives and a skilled labour force as a long-term strategic response to the increasingly challenging business environment. In addition, highly centralised business model structures resulting from supply-chain restructuring became more common within multinational enterprises (MNEs) with a concentration of high-value intangibles and entrepreneurial functions and risks in tax-advantaged jurisdictions.

In 2010, Italy introduced penalty protection documentation rules together with early recognition of the 2010 OECD Guidelines. Now, Italy also requires reporting of the totals of inter-company transactions in the annual tax return. These latter developments have significantly enhanced the profile of TP in Italy with a much broader level of awareness and general interest. From the perspective of the Italian tax authorities TP has also become one of their key audit and tax adjustment areas in the past year.

Legislation and guidance

Statutory rules

Statutory rules on TP are set out in Article 9 and Article 110 of the Italian Income Tax Code.

Article 110, paragraph 7, states that components of the income statement of an enterprise derived from operations with non-resident corporations that directly or indirectly control the enterprise are controlled by the enterprise or are controlled by the same corporation that itself controls the enterprise, should be valued on the basis of the normal value of the goods transferred, services rendered and services and goods received, if an increase in taxable income would arise thereby. Possible

reductions in taxable income as a result of the normal value rule are allowed only on the basis of mutual agreement procedures (MAPs) or the European Union (EU) Arbitration Convention.

Article 9, paragraph 3, states that 'normal value' means the average price or consideration paid for goods and services of the same or similar type, carried on at market conditions and at the same level of business, at the time and place in which the goods were purchased or the services were performed. For the determination of the normal value, reference should be made to the extent possible to the price list of the provider of goods or services. In the absence of the provider's price list, reference should be made to the price lists issued by the chamber of commerce and to professional tariffs, taking into account usual discounts.

Other regulations

The translation of the above statutory rules into operating guidelines was effected through the Ministry of Finance instructions in Circular Letter No. 32/9/2267, dated 22 September 1980. The Circular Letter provides principles and methods to be used in determining normal value. As it is based on the 1979 OECD Transfer Pricing Report, and the TP documentation provisions introduced by Law Decree 78 of 31 May 2010 make clear reference to the 2010 OECD Guidelines, its current status is now unclear. Tax auditors have used the Circular Letter for many years and may continue to do so, although this is discouraged by the International Office of the ITA. In some cases, local practice in the field continues to vary from the most up-to-date OECD position.

Transfer pricing documentation provisions have been included in Law Decree 78 of 31 May 2010, which was converted into Law 122 of 30 July 2010. The law provides a penalty protection regime for companies that comply with the documentation requirements including the detailed format as set out in a Regulation dated 29 September 2010 and which notify possession of documentation when they file their tax returns. The provision of compliant documentation relieves taxpayers from the normal regime of tax-geared penalties on adjustments insofar as the adjustment relates to a TP matter.

Risk transaction or industries

In 2008, the Italian tax authorities (*Agenzia delle Entrate*) issued Circular Letter n. 6/E, dated 25 January 2008. The circular highlights for consideration, international TP as well as inter-company transactions between resident Italian companies when TP issues could affect the amount of tax paid overall because of the presence of a favourable tax regime, for example. The focus on TP was confirmed by circular letters in successive years (Circular Letter n. 13/E of 9 April 2009, Circular Letter n. 20/E of 16 April 2010, Circular Letter n. 21/E of 18 May 2011 and Circular Letter n. 18/E of 31 May 2012). Circular Letter 25/E dated 31 July 2013 confirms that the guidelines provided by these circulars are still valid, adding that priority should be given to base erosion and profit shifting (BEPS) issues, mentioning explicitly the OECD work on this topic. Circular Letter n. 25/E dated 6 August 2014 confirms these principles and highlights the increase in the number of Mutual Agreement Procedure.

The Italian Tax Police (*Guardia di Finanza*) issued Circular Letter n.1/2008 containing guidelines to be followed by its officers when performing tax audits. Chapter 6, titled 'International Tax and Tax Audits Methodologies', provides specific operative guidelines for tax officers when they assess companies on TP and PE issues.

The circular provides specific criteria for officers to identify Italian companies whose inter-company transactions warrant particular attention. The following are specifically mentioned and are typical of the type of transaction where emphasis is placed in practice:

- Transactions with foreign-related companies in jurisdictions where they benefit from favourable tax regimes.
- Transactions concerning intangible assets (such as royalties) and services (management fees).
- Transactions where the Italian company acts as a mere intermediary (commissionaire, agent) and receives a commission-based remuneration.
- The sale of high-value intangible properties by the Italian company to foreign entities.

Deductibility of interest payable
From 2008, under Article 96 of Income Tax Code, interest expense is deductible up to the amount of interest income. Excess interest expense is deductible up to 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA) (interest deduction capacity). The non-deductible amount may be carried forward indefinitely. If net interest expense is less than 30% of EBITDA, the difference can be carried over to increase the company's interest deduction capacity in future years.

Penalties

Italian tax law requires taxpayers to file tax returns, maintain tax books and records, withhold tax at source, etc. If the taxpayer does not fulfil these obligations, then administrative – or in certain cases, criminal penalties – may be imposed. The general penalty regime applies to TP.

Administrative penalties range from 100% to 240% of the amount of tax unpaid. Special rules apply where similar violations are repeated over various fiscal years. Administrative penalties arise because of an adjustment. There is no need for the tax authorities to adduce negative taxpayer behaviour for penalties to arise.

Penalties may be reduced to different levels in case of spontaneous disclosure or early settlements.

Only for regional tax purposes (IRAP) penalties do not apply for challenges relating to fiscal years from 2008 to 2012.

Penalties may be reduced as follows:

- To one-eighth of the minimum (i.e. 12.5% of tax on adjustment) for spontaneous disclosure (without any tax audit in place).
- To one-third of the minimum (i.e. 33%) if the taxpayer agrees to pay the taxes assessed within 60 days from issuance of the official notice of assessment. The penalty is reduced even further to one-sixth, but only if the taxpayer agrees to all adjustments proposed at the end of the audit within 60 days and before the issue of a formal assessment.
- To one-third of the minimum (i.e. 33% of tax agreed) for a negotiated settlement following the issue of a tax assessment (*Accertamento con Adesione*).
- To 40% of tax agreed in the event of the judicial settlement procedure.

The tax office has four years from the end of the year in which the tax return was filed to issue assessments for additional tax. This term is doubled if a criminal report is issued (applicable generally if the adjustment exceeds 2 million euros [EUR]). The period is five years if no return was filed and it could also be double in case a criminal report is issued.

Based on Legislative Decree n. 74 dated 10 March 2000, TP adjustments may also trigger criminal penalties in addition to the administrative sanctions outlined above as related to issues of 'valuation'. The Italian tax authorities notify the outcome of a TP assessment to the local public prosecutor when the adjustment amount exceeds the relatively low threshold for notification.

In cases of a TP adjustment, no administrative penalty should apply if the taxpayer has prepared documentation to support its inter-company transactions drawn up in accordance with the 29 September 2010 Regulation and had notified possession on its tax return. If, during a tax audit, a taxpayer is not able to deliver documentation for which a formal notification has been made, the tax authorities may take account of such behaviour in the event of a TP adjustment to determine the suitable level of penalties applicable. The implication is that the level of penalty would be set higher in the range (100% to 200% with reductions for early settlement) than would otherwise apply.

Documentation

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Transfer pricing documentation provisions were included in Law Decree 78 of 31 May 2010, converted into Law 122 of 30 July 2010, with effect from 2010. Detailed specification about the form and content of this documentation are contained in the Regulation of 29 September 2010.

The Regulation is based on the EU Code of Conduct for Transfer Pricing Documentation and uses the concept of master file and country file. Italian-based groups, which include non-Italian subsidiaries, must produce both a master file and a country file; Italian subsidiaries need produce only a country file. An Italian subholding company with at least one non-Italian subsidiary must produce a subholding master file as well as a country file, although it can choose to produce the group master file if compliant as to form and content. This requirement of a subgroup master file also applies to an Italian branch of a company that has non-Italian subsidiaries, regardless of whether the investments are held by the Italian branch.

Both documents must be prepared in Italian, but an Italian subholding company can produce a master file in English, provided the file is for the entire EU-based group. Annexes can be in English.

While documentation is not mandatory, the regulation indicates that whether or not a company has communicated the existence of such documentation will influence the tax authorities in their risk assessment and as an indication of taxpayer transparency and willingness to cooperate. Documentation that is considered to meet the requirements of the regulation will protect taxpayers from tax-geared penalties on any TP adjustments. The format is prescribed in detail and is mandatory. Although a number of interpretative points still remain unclear, further guidance was provided on tax authority expectations in Circular Letter 58 issued on 15 December 2010.

The penalty protection is also applicable to past open years if the taxpayer has notified possession of such documentation by 28 December 2010 or at any point thereafter until a tax authority audit or visit takes place. However, once an audit has begun, the opportunity has passed.

On tax auditor request, the documentation must be produced within ten days. Taxpayers have a further seven days to produce additional supplementary information if requested. If the taxpayer is unable to meet these deadlines, penalty protection is lost.

Transfer pricing documentation must be produced annually and on a company-by-company basis, although large companies may produce divisional files. Small and medium companies (defined as those with a turnover of less than EUR 50 million) need to perform the method selection and economic analysis part of the documentation, only every three years, provided there has been no significant change in the business and that the economic analysis is based on publicly available databases.

Documentation needs to be signed on each page by the company's legal representative.

The regulation does not impose specific methodologies but refers in general to the 2010 OECD Guidelines and emphasises the preference for traditional transaction-based methods. Transaction profit-based methods are acceptable, provided there is sufficient justification in the presence of potential traditional transaction-based methods, of the reasons why the latter are not used.

General rules on tax documentation also continue to apply to inter-company transactions. Accordingly, the company should be able to adequately substantiate all income and expense items.

The ITA may require taxpayers to produce documents or other information (also in the form of answers to questionnaires) during an audit. In this case, taxpayers are obliged to comply with the requests. If a taxpayer fails to submit documentation within the timeframe provided in the tax authorities' request, an assessment may be made based on the tax authority's assumptions.

Use and availability of comparable information

Use

To support the TP policy applied, documentation is expected where appropriate to include a benchmark analysis showing that the results earned by the company fall within the arm's-length range of results realised by comparable companies. Under the penalty protection rules the Italian tax authorities have indicated that, except for small and medium-sized enterprises (SMEs) (turnover less than EUR 50 million), they expect to see a new benchmark (including a new selection process) each year. As mentioned, SMEs can update the benchmark analysis every three years.

Availability

Italian companies are required by law to file their financial statements with the local chamber of commerce. In this respect, it is possible to obtain detailed data on the results of other companies including extensive notes in many cases. These can be accessed online both by taxpayers and the tax authorities. There are databases allowing research of comparable companies at the European and Italian levels. The Italian tax authorities have access to these.

Transfer pricing controversy and dispute resolution

Tax audit procedures

Selection of companies for audits

The ITA focuses its attention on major taxpayers and hence on multinationals.

From 2002, taxpayers with turnover above approximately EUR 26 million are expected to be systematically audited at least once every two years. Also, from 2002, taxpayers with turnover exceeding EUR 5.2 million will be systematically audited at least once every four years. These audits may be complete and extensive or focus just on specific items such as TP. Even if these parameters, introduced by Article 42 of Law 388 of 23 December 2000, are not consistently met, they are considered as a general guideline for tax audits.

Law Decree No. 185 of 29 November 2008 also provided that companies with revenue exceeding EUR 100 million will be subject to substantial checks on their income tax and VAT returns in each fiscal year following that in which the filing has been made (so-called *'tutoraggio fiscale'*).

The existence of inter-company transactions or transactions with blacklisted countries are considered by the tax authorities in their risk assessment analysis as confirmed by Revenue Office Circular 25/E, dated 31 July 2013 and Circular 25/E dated 6 August 2014. The amount of these transactions must be included in the annual tax return and, as a result, are immediately visible.

With limited exceptions, corporations that are repeatedly in a tax loss position will be subject to specific controls.

The ITA is also increasing the level of exchange of information with foreign tax authorities.

The audit procedure

Tax audits in Italy are normally carried out on the taxpayer's premises. The audit visit may be preceded by a formal request for information by the tax authorities, but normally tax audits are not announced in advance.

Apart from exceptional cases, the duration of an onsite tax audit may not exceed 60 days (ordinary period of 30 days which can be extended with a further 30 days) of presence at the taxpayer premises. At the end of the audit, the tax authorities release a report with findings and proposed adjustments.

The company may file a defence brief or rebuttal against the tax audit report with the relevant tax office within 60 days. Until the 60 days have elapsed, the tax office may not issue a tax assessment. The tax authorities will not necessarily issue an assessment immediately after the 60 days expire, and the formal assessment may not appear for some time. The tax authorities must, however, respect the time limits provided by Italian statute.

Tax issues including TP may be settled with the tax authorities without litigation. The relevant procedure was introduced by Decree 218/1997 and is called *'accertamento con adesione'*. If an agreement is reached, an official report is drawn up showing the amount of taxes, interest and penalties due. In the event a settlement is reached and

the taxpayer does not already benefit from penalty protection relief, penalties are reduced to 33% of the total amount due.

Once litigation commences, the company and the tax authorities may still settle the dispute out of court. Indeed, they are required to consider this option if they have not already done so. The procedure, introduced by Article 48 of the Decree 546/1992, is called the judicial settlement procedure. In the event a settlement is reached during the judicial settlement procedure and the taxpayer does not already benefit from penalty protection relief, penalties are reduced to 40% of the total amount due.

If the dispute is decided in court against the taxpayer, penalties, if due, are applied in full. There are three stages before a final judgment is reached with no further prospect of appeal: First Instance (provincial), Second Instance (regional) and Supreme Court, or *Corte di Cassazione*. Unless a suspension is obtained while the dispute is pending, the tax authorities are allowed to collect 33% (reduced from 50% by Law Decree 70/2011) of the tax assessed before the first instance decision is given; two-thirds of the tax (and penalties) due following the first-degree judgment; and the total taxes (and penalties) due following the second-degree judgment.

Resources available to the tax authorities
There are units dedicated to TP, and the number of audits has increased in recent years. There are more qualified personnel performing audits, and staff members in local offices also have received TP training. There is an improved level of preparation and appreciation of resources that can be used in conducting TP audits.

A technical team of officers specialising in TP exist within the Large Taxpayer Office (the regional office responsible for auditing companies with a turnover in excess of EUR 100 million), which provides technical support to the specific client audit teams.

Burden of proof
The general principle states that the burden of proof lies with the ITA; however, the taxpayer is expected to demonstrate the fairness of its inter-company transactions in case of assessment by the tax authorities. This general principle also has been confirmed by the above Supreme Court's decision dated October 2006; by Judgment No. 52 of Tax Court of Pisa, dated February 2007; by Judgment No. 134, dated 21 March 2011, of the Provincial Tax Court of Reggio Emilia; by Judgment No. 11949, dated 13 July 2012, of the Supreme Court; by Judgment No.4927, dated 27 February 2013, of the Supreme Court; by Judgment No. 83 and No. 84, dated 10 July 2013, of the Regional Tax Court of Milan.

On the other hand, for transactions with related or unrelated companies located in the so-called blacklisted countries, the Italian taxpayer, in order to deduct the relevant costs, must provide evidence that the foreign party is a genuine commercial undertaking or that the transactions were performed for a real economic interest and that the relevant transaction actually took place. The related costs must be indicated in the annual tax return, otherwise penalties will be applied.

Particular rules apply to cross-border transactions involving counterparties (including third parties) resident in tax havens. The Italian taxpayer, in order to deduct the relevant costs, must provide evidence:

- that the foreign party is a genuine commercial undertaking, and
- that the transactions were effected in connection with a real economic interest and that the relevant transactions actually took place.

The costs must be disclosed in the company's tax return; otherwise, penalties will apply. The rules relating to such costs ('Black List' transactions) are independent of Italian TP rules.

Legal cases

In recent years, there have been a number of court decisions relating to TP. Some important cases are summarised below; they provide general principles on various points (i.e. concept of free competition, arm's-length definition, burden of proof and necessary documentation for deducting inter-company service charges). Decisions from the Supreme Court represent the final judgment in an Italian tax case. Provincial and regional tax court decisions represent first and second instances.

Judgment No. 13233 of the Supreme Court, fiscal division (October 2001)
Judgment No. 13233 deals with the concept of 'free competition'.

The Italian company subject to assessment (ITCO) purchased goods from its foreign parent. The Italian tax authorities adjusted the purchase price on the grounds it was not at arm's length. ITCO appealed to the Court and claimed that TP provisions were not applicable in its case due to the absence of free competition in this sector in Italy; only one other Italian company produced the same product, and this was under licence from its foreign parent. The Court determined that in order to speak of 'free competition', it is enough that a similar product is sold in Italy without any legal restriction on pricing. There is no need to have 'ideal' free competition. For this reason, the Court rejected the appeal.

Judgment No. 130 of the Regional Tax Court of Tuscany (January 2002)
Judgment No. 130 concerns the definition of 'arm's-length value'.

The Tax Court stated that normal value can be determined by reference to average data from the sector in particular, data provided by the trade association to which the Italian resident company belongs, or data confirmed by financial statements from Italian companies in the same sector.

Judgment No. 253 of the Provincial Tax Court of Ravenna (November 2002)
Judgment No. 253 concerns a non-interest-bearing loan made to a controlled non-resident company.

ITCO granted a non-interest-bearing loan to a controlled company resident in Luxembourg. The ITA assessed interest income at the 'normal value', based on the Italian Bankers Association (ABI) prime rate. ITCO was not able to justify the reasons for having granted a significant non-interest-bearing loan to its foreign affiliate when ITCO bore interest costs on its own external debt. The Tax Court recognised that the inter-company loan should have generated interest receivable for the Italian company as argued by ITA.

Judgment No. 1070 of the Provincial Tax Court of Vicenza (February 2003)
Judgment No. 1070 concerns inter-company sales made without mark-up.

The ITCO sold raw materials to a German related company at a price equal to purchase price without any mark up. Based on data in the company's financial statements, ITA derived an average markup on costs realised by ITCO in its other operations (38%) and applied this markup to the sale of raw materials.

The Tax Court determined that the assessment should be cancelled for the following reasons:

- The operation under review was of negligible value compared with the volume of purchases and sales made by ITCO as a whole.
- The operation was not comparable with the company's usual inter-company transactions (ITCO's business activity consisted of sales of finished products).
- The operation was undertaken for the purpose of allowing the German company to produce a particular product for sale to an important Italian client. The aim was a significant increase of ITCO's overall business.

Judgment No. 13398 of the Supreme Court, fiscal division (September 2003)
Judgment No. 13398 concerns the burden of proof.

ITCO (in a tax loss position) applied to sales made to its French parent company, a 6% rebate, once a certain sales threshold was reached. The ITA considered the rebate had not been justified by reference to costs and risks borne by the French company and consequently determined an adjustment on ITCO, arguing that the company should have demonstrated that the rebate was justified by reference to distribution costs and risks borne by the parent company and consequent savings for ITCO. A matching of savings and rebates was considered necessary to show that the prices applied were in line with those applied to the third parties.

The Court decided that in the absence of the required benefits' demonstration, the ITA adjustment was correct.

Judgment No. 158 of the Provincial Tax Court of Milan (June 2005)
Judgment No. 158 concerns the documentation necessary to support the deductibility of inter-company services charges.

The ITCO received charges from its foreign parent company under a multilateral service agreement. These charges were considered non-deductible by the ITA, due to alleged lack of documentation.

The Milan Tax Court decided in favour of ITCO, judging that it had presented sufficient documentation to show the certainty of the costs sustained and that the costs were related to ITCO's business, including:

- Written agreement describing the services provided.
- Comfort letter issued by a major audit firm attesting that the cost allocation had been correctly performed and that the attribution of costs to the various group entities had been made on the basis of the benefits they received.
- Invoices containing a detailed description of the services performed.

- Demonstration that the costs borne, with reference to the services received, were correctly recorded in the accounting records and included in the financial statements of the Italian company.
- Documentation describing, for each type of service, the nature of the activity performed and the advantage received by the Italian company.

Judgment No. 22023 of the Supreme Court, fiscal division (October 2006)
Judgment No. 22023 sets out the important principle that the inappropriateness of a company's transfer pricing must be proved by the ITA, which bears the burden of proof that the company does not comply with the arm's-length principle.

The ITCO, which purchased cars from foreign-related companies, bore repair and maintenance costs on new cars, without adequate remuneration. The ITA argued that this caused a reduction in the Italian tax base and an increase of profit for related companies resident in low-tax jurisdictions, but did not provide any real evidence of this.

The court decided in favour of ITCO because the ITA did not demonstrate that the group's TP was unfair. The court referred to the OECD Guidelines, which expressly state that if the local jurisdiction provides that the tax authorities should set out the reasons for any adjustment, the taxpayer is not obliged to prove the correctness of its transfer prices unless the tax authorities have first demonstrated (at least *prima facie*) that the arm's-length principle has not been observed.

Judgment No. 52 of the Provincial Tax Court of Pisa (February 2007)
Judgment No. 52 concerns the applicability of the CUP methodology.

The ITA issued a notice of assessment on the ITCO, a company operating in the garden pumps market, to cover revenue resulting from the sale of products to a French-related party at a price lower than normal value. The ITA compared the sale prices applied to third parties with those applied to the French-related company, observed that the inter-company prices were lower by about 10%, and assessed the difference.

However, the Court agreed with the arguments of the taxpayer, which demonstrated that the transactions taken by the ITA were not comparable as regards to the stage of commercialisation, the volumes involved and the number of shipments. These differences would have been sufficient to justify a 10% difference in the sale price. The Court stated that the ITA should at least have carried out an analysis of the tax rates in force in the two countries and of the comparable transactions.

Judgment No. 9497 of the Supreme Court, fiscal division (April 2008)
Judgment No. 9497 concerns the power of the ITA to verify the appropriateness of compensation agreed between Italian resident companies.

ITCO had an existing contract with its directly controlled Italian refinery for the receipt of certain refinery oil services. The refinery compensation was guaranteed to cover all the plant's fixed costs and variable costs and provide a fair profit margin.

Both the ITA and the provincial tax court disallowed the profit margin paid by ITCO to the refinery. However, the regional tax court decided that the service received by ITCO was definitely related to its own operations, and any requirements in TP and anti-avoidance provisions that would allow the ITA to disregard the agreement between the parties were not met.

The Supreme Court revoked this judgment, determining that the ITA may verify the amount of costs and profit in financial statements or tax returns and make relative adjustments where there are no accounting irregularities or errors in legal documents. The ITA may deny deductibility, in whole or in part, where a cost is considered to be without foundation or is disproportionate. Therefore, the ITA is not bound to the values or the compensation arrived at in company decisions or contracts.

Judgment No. 20 of the Regional Tax Court of Emilia-Romagna (April 2008)
Judgment No. 20 concerns the deductibility of management costs derived from a written contract between the parties prior to the cost recharge and the use of a percentage of turnover mechanism.

ITCO was charged certain management costs by its parent based on a lump sum linked to estimated turnover. The ITA disallowed the deductibility of these costs as there had been no analysis of their nature and, therefore, it might be assumed some were not relevant to ITCO's business.

ITCO argued that although it was part of a group, it was not wholly controlled, as there was a 35% minority interest. The services were agreed and performed on the basis of a written agreement signed before the fiscal year in question. The contract stated remuneration for these services (equal to 2.86% of turnover), which should be considered arm's length.

The Regional Tax Court agreed with the taxpayer arguments taking into account the fact that the ITA's case was based on mere assumption. The ITA did not prove the absence of services or that the services had no bearing on ITCO's business.

Judgment No. 87 of the Regional Tax Court of Lombardy (March 2009)
Judgment No. 87 concerns the application of the arm's-length principle to inter-company sales in a multinational group.

The ITA issued a notice of assessment on ITCO (a contract manufacturer) for fiscal year 2003, on the basis that ITCO had sold finished goods to a Swiss-related company at a price lower than the arm's-length price in order to transfer income to Switzerland. The ITA's challenge was based on the fact that the Swiss company sold the same products to an Italian reseller in the group at a higher price.

The ITCO claimed the higher price charged by the Swiss company to the Italian reseller was justified for the following reasons:

- The Swiss company owned the trademarks and patents; performed research and development; and bore the foreign exchange, credit and inventory risks.
- ITCO performed manufacturing for the Swiss company and did not bear any inventory risk as a contract manufacturer.
- The Italian reseller performed finishing activities based on local market preferences and managed the sales network.

The Court cancelled the assessment, as it did not consider the ITA had discharged the burden of proof to show the prices to be non-arm's length. Moreover, the Court considered that the sales prices from ITCO to the Swiss company were in line with those applied by the Swiss company.

Judgment No. 5926 of Supreme Court, fiscal division (March 2009)
Judgment No. 5926 concerns the deductibility of inter-company costs charged by a non-resident entity to its permanent establishment in Italy.

The case dealt with the determination of certain overhead costs (administrative expenses, flight operations and maintenance of the fleet) related to the international airline business and paid by a company resident outside Italy, also for its PE in Italy.

The ITA issued a notice of assessment on ITCO for 1998, disallowing costs that it considered undocumented. The provincial tax court confirmed the ITA's position. ITCO appealed to the Supreme Court, claiming that it was not possible to make a detailed individual analysis of costs as they were incurred by the overseas company and charged pro rata to the branches based on the latter's sales. The financial statements and the auditor's report were appropriate to support the non-resident company costs charged to Italy, unless the tax office could show error committed by the auditor.

The Supreme Court agreed with the taxpayer and confirmed that the auditor's report on the financial statements was sufficient to support the costs registered in the annual financial statements.

Judgment No. 396 of the Provincial Tax Court of Milan (January 2010)
Judgment No. 396 concerns the transfer of functions and risks from an Italian company to another firm of the group for registration tax purposes.

The case dealt with the conversion of an Italian entity operating as a fully fledged manufacturer into a toll manufacturer with the relocation of certain functions and risks to a Swiss-related company. The ITA argued that this operation represented a transfer of a going concern, subject to registration tax.

The ITA issued a notice of assessment, which was challenged by ITCO. The Provincial Tax Court of Milan determined that the mere transfer of risks and functions does not represent a business transfer and therefore no registration tax was due.

Judgment No. 7343 of the Supreme Court, fiscal division (March 2011)
Judgment No. 7343 concerns the application of rebates on inter-company sales.

The case regards the application of discounts granted by ITCO on sales to inter-company entities. The ITA made a TP adjustment, disallowing the discounts on the grounds that no discount was granted on sales to third parties. ITCO argued that the transactions were not comparable since the goods sold to related parties were at a different stage in the production/distribution chain. The Supreme Court confirmed the ITA view rejecting ITCO's arguments as to lack of comparability.

Judgment No. 134 of the Provincial Tax Court of Reggio Emilia (March 2011)
Judgment No. 134 concerns the possibility that the taxpayer is exempted from the burden of proof.

The Court stated that the burden of proof in TP cases is on the ITA, which has to demonstrate that the inter-company transactions, as implemented by ITCO, were not at arm's length. The ITA has to determine the 'normal value' of the transaction and demonstrate that a tax advantage was achieved by ITCO (i.e. taxation in the counterparty's country was lower than in Italy).

Judgment No. 580 of the Regional Tax Court of Lazio (September 2011)
Judgment No. 580 concerns the application of a different transfer pricing method by the ITA compared to the method selected by ITCO for its inter-company transactions.

The taxpayer calculated its inter-company prices, based on the return on capital employed (ROCE). ITA argued that the ROCE was not the appropriate ratio and made a TP adjustment, based on what is described as transactional net margin method (TNMM), but without further reference to the ratio.

The Tax Court of Lazio rejected ITA's challenge based on the following reasons: ITA should have demonstrated both the lack of economic reasons underlying the ROCE and that ITCO was pursuing a tax avoidance strategy. The Court stated that since ITA did not provide the above evidences and ROCE is an indicator provided by OECD, the application of an alternative method compared to the one chosen by the taxpayer was not legitimate. The Tax Court also commented on the benchmark analysis performed by ITA recognising the lack of comparability of some comparables found by the Office.

Judgment No. 129/19/2011 of the Regional Tax Court of Lombardy (October 2011)
Judgment No. 129 concerns the burden of proof in relation to transfer pricing disputes.

This case concerned the prices applied by an Italian manufacturer to the Group Swiss Principal. In particular, the ITA compared these prices with the prices at which the principal sold the same goods to an Italian-related distributor. This approach resulted in an adjustment since the prices between the principal and the distributor were higher than those applied by the manufacturer to the principal. The Tax Court rejected the ITA's adjustment for the following reasons: the prices between the principal and the distributor, as inter-company prices, do not represent a market comparable; the company demonstrated the business reasons of the principal structure; the ITA did not challenge any violation of tax law in Switzerland or Italy; the fact that both the manufacturer and the distributor are resident in Italy and their premises are close to each other is not relevant since the whole business model underlying the transactions needs to be considered.

Judgment No. 99 of the Provincial Tax Court of Milan (March 2012)
Judgment No. 99 concerns the benefits of collaborative conduct by the taxpayer before the entry into force of the 'penalty protection' regime.

ITCO purchased from related parties goods for distribution. The ITA adjusted the purchase prices applying the resale price method (RPM) while the taxpayer argued that the TNMM was more appropriate.

The Court stated that the RPM, as supported by ITA, was appropriate to this case and so an adjustment was due to the transfer prices. However, the Court agreed with the taxpayer that no administrative penalties were due, even though no communication of possession of TP documentation had been made, as provided by the Regulation of 29 September 2010 in view of the collaboration exhibited by the taxpayer and the fact that the assessment concerned fiscal years before the implementation of the Documentation Regulation.

Judgment No. 80/27/12 of the Regional Tax Court of Lombardy (June 2012)
Judgment No. 80 concerns the deductibility of inter-company services charged.

The case relates to a challenge by the ITA to the deduction of costs charged by its French parent to ITCO for administrative, legal, accounting and fiscal services, and the costs related to the implementation and maintenance of operating software. In particular, the ITA challenged that these costs were not deductible because the taxpayer did not demonstrate that these were relevant to its business activity (Art. 109, paragraph 5 Italian Tax Code).

ITCO, in order to prove the deductibility of the costs, produced: the inter-company contract signed before the services were provided, describing the nature of services provided; the monthly reports summarising the activities performed by the service provider; spreadsheet showing the costs incurred by the service provider and the allocation of these costs to the Group recipients.

The Regional Tax Court stated that the evaluation of the deductibility of service costs should be made applying the TP principles stated by the OECD, particularly regarding the analysis of the benefit provided to the recipient. According to the Tax Court, the existence of the above-mentioned documentation and, in particular, the consistency between the contractual provision and the services actually supplied, was sufficient to demonstrate the actual provision of the services and the benefit for the recipient. Therefore, the Tax Court acknowledged the deductibility of the service costs.

Judgment No. 11949 of the Supreme Court, fiscal division (July 2012)
Judgment No. 11949 concerns the burden of proof in case of adjustment of costs.

ITCO was an Italian distributor of software purchased from a UK-related party. Close to the year-end, ITCO received a TP adjustment from the UK entity increasing the transfer prices of the goods supplied during the year. The ITA challenged the deduction of this year-end adjustment. It is worth mentioning that the Regional Tax Court denied the ITA challenge. The Supreme Court acknowledged that the arm's-length principle (Art. 110, paragraph 7 of the Italian Income Tax Code) is an anti-avoidance provision and, accordingly, the burden of the proof of the taxpayer's avoidance aims lies with the tax authorities. However, since the challenge considered here related to inter-company costs incurred by the Italian taxpayer, the latter has to demonstrate that the costs are necessary for its business activity and resulted in a benefit for the Italian taxpayer.

The Supreme Court stated that the ITCO did not provide evidence of the benefit deriving from the costs challenged, particularly regarding the year-end adjustment; the TP study prepared by the company to support its TP was not considered sufficient.

Judgment No. 96/4/12 of the Provincial Tax Court of Como (October 2012)
Judgment No. 96/33/13 concerns the royalty rate applied by a Swiss entity to its Italian subsidiary for the use of trademark.

The decision concerns the royalty rate applied by a Swiss entity to its Italian subsidiary for the use of a trademark. The ITA challenged the contractual royalty rate, equal to 5.1%, adjusting the rate to 2%, based on certain rules of thumb contained in the 1980 Circular 32.

ITCO provided significant documentation in order to prove the high-tech nature of the sector in which it operates and the need to periodically realise and promote new products.

The Court accepted the Italian taxpayer's arguments stating that royalty payment of any amount (in this case the royalty rate contractually established), paid to entities resident in low taxation countries are deductible if the conditions of substance provided by the Circular are met.

Judgment No. 61/05/12 of the Provincial Tax Court of Como (December 2012)
Judgment No. 61 concerns the value of the markup applied on inter-company sales.

ITCO purchased fabrics from an independent Spanish supplier and sold them to its French parent company, applying a markup equal to 0.54%. The ITA challenged the transfer price due to the small mark-up applied, stating that this meant the inter-company transaction did not have economic rationale for the Italian entity as the mark-up applied was not sufficient to remunerate the functions and to cover the fixed costs and operating expenses of ITCO.

The ITCO proved that the transaction was an occasional operation which was convenient from an economic perspective and, in order to prove the arm's-length value provided invoices from other third-party yarn suppliers to the French parent, which showed that the prices applied by the third-party suppliers were in line with those applied by ITCO.

The judges rejected ITA's challenge and accepted the Italian company's appeal, stating that the ITA had not proved either the lack of commercial rationale of the inter-company transaction or the non-arm's-length nature of the mark-up.

Judgment No. 56/33/13 of the Regional Tax Court of Lombardy (May 2013)
Judgment No. 56/33/13 acknowledged the key role of business strategies and economic circumstances underlying the activity the inter-company transactions to determine the arm's-length prices.

ITCO was responsible for the production of basic chemical compounds, which were sold to related parties. In the fiscal year assessed (2006), the prices applied to these sales decreased to such an extent that ITCO was not able to cover all its production costs. The ITA adjusted the transfer prices applying a cost plus (CP) approach.

The taxpayer defended the transfer prices applied with a range of arguments such as: depreciation of the US dollar (the currency of the transaction), the fact that inter-company production allowed ITCO to cover part of its fixed costs and that ITCO was in an overall profit position. ITCO also argued that the CUP method was the most appropriate and provided proposals from Chinese third-party suppliers with prices lower than those applied by ITCO for its the inter-company sales.

The Provincial Tax Court accepted ITCO arguments mentioned above. The Regional Tax Court of Lombardy confirmed this judgment placing significant emphasis on the need to consider the specific circumstances as the taxpayer had proposed and accepting the CUP method as the most appropriate in this case.

Judgment No. 10739 of the Supreme Tax Court, fiscal division (May 2013)
Judgment No. 10739 concerns the burden of proof in transfer pricing litigation.

As a result of a tax audit related to fiscal year 2003, the ITA adjusted the price of intercompany sales of ITCO, disallowing certain discounts applied by ITCO which, in the ITA's view were not compliant with the Italian TP rules.

The Regional Tax Court of Emilia Romagna accepted the taxpayer appeal stating that the ITA had not proved that the tax rates in the countries of the counterparties were lower than in Italy.

The ITA appealed the Regional Court decision to the Supreme Court arguing that the TP rules should not consider overall group taxation, but requires a fair determination of the relevant prices applied in order to ensure the fair calculation of taxes in Italy.

The Supreme Court accepted the appeal of the ITA, stating that the Italian TP rule, as those applicable in other countries, does not require the demonstration of a higher tax rate in Italy compared to that in the country of the counterparty. A TP adjustment can be made without any proof of tax avoidance.

Judgment No. 83/13/2013 of the Regional Tax Court of Milan (July 2013)
Judgment No. 83 concerns the burden of proof in transfer pricing litigation.

The case concerns an assessment of the transfer prices paid by an ITCO to its French parent company for the purchase of goods.

The ITA adjusted the transfer prices using as reference the results of a competitor of ITCO, which belonged to a multinational group, on the grounds that this was the only really comparable business.

The taxpayer defended its position, arguing that no tax saving was derived by the group from these transactions considering the similar level of taxation of the two countries involved. ITCO did not provide proper documentation to support the transfer prices applied.

The Court stated that even though the ITA's challenge was not in line with the OECD Guidelines which requires comparables to be independent, the adjustment was based on a complete analysis and proper documentation, while ITCO had not properly supported its TP with specific studies.

Judgment No. 84 of the Regional Tax Court of Milan (July 2013)
Judgment No. 84 concerns the burden of proof in transfer pricing litigations.

The case concerns a tax assessment whereby the ITA challenged that the transfer prices applied by ITCO to a Chinese distribution company for thermoplastic materials were lower than the arm's-length value and that they were determined on a subjective basis.

ITCO filed an appeal arguing the non-applicability of Article 110, Paragraph 7 of ITC, considering also the lack of a tax advantage at the group level.

The first-degree court accepted ITCO's arguments. However, the Regional Tax Court stated that the taxpayer had not provided the tax auditors with appropriate documentation to support the transfer prices applied, but only 'an insufficient memorandum (…) which did not provide specific indication – either qualitative or quantitative – in relation to the determination of the arm's length'. The Court stated that Article 110, Paragraph 7 of ITC applies, regardless of whether a tax saving is obtained at the group level.

Judgment No. 22010 of the Supreme Court, fiscal division (September 2013)
Judgment No. 22010 concerns the application of the CUP method.

The case concerned the deduction of interest from a German parent company on an inter-company loan to its Italian subsidiary.

The ITA challenged the arm's-length nature of the interest paid on the grounds that the rates used were higher than the average rates applied in the German market, which was used as the reference market.

The regional tax court accepted the ITA's interpretation. ITCO filed an appeal arguing that the ITA did not demonstrate any tax advantage nor any tax avoidance purpose in the taxpayer's conduct.

According to the Supreme Court, the average interest rates applied in the German market and published in the Official Bulletin of the Bundesbank were the appropriate rates to use in a CUP method in compliance with the Italian legislation, since the market of the lender should be considered as the reference market.

Judgment No. 24005 of the Supreme Court, fiscal division (October 2013)
Judgment No. 24005 concerns the application of the CUP method.

The case concerns an Italian company that sold goods (soda and sodium bicarbonate) both to its Belgian parent company and to third parties in the Italian market.

The ITA based its adjustment on the fact that the prices applied to Italian third parties were 44% higher than those applied to the Belgian-related party. ITCO argued that the market to be considered in determining the 'normal value' of the goods sold should be the market of the distributor (i.e. Belgium), not that of the seller.

The ITA argued that the relevant market in this case could not be Belgium since the latter was dominated by affiliated companies. The Regional Tax Court however judged in favour of ITCO.

The ITA appealed to the Supreme Court, which accepted the ITA's arguments and its internal CUP analysis on the grounds that the price comparison should be made, where possible, based on the price list of the supplier.

Judgment No 240054 of the Regional Tax Court of Milan (June 2014)
Judgment No. 240054 concerns the selection of transfer pricing methods and profit indicator.

The case concerns an Italian company operating in the jewelry industry which sells goods to its foreign parent company and this latter distributes them to third parties after some assembly activities. The company adopted the cost plus method to support its transfer prices.

The ITA challenged the use of the cost plus method and applied the TNMM selecting the Return on Cost (ROC) (Operating profit/Cost of personnel) as Net Profit Indicator.

In the recourse the taxpayer argued that traditional method, such as cost plus, should be preferred where applicable. It also argued against the analysis of the ITA challenging that the ROC, as calculated by the ITA, was not suitable as it considered only personnel costs and the companies selected in the sample produced by the office were not comparable.

The Regional Tax Court accepted the taxpayer's appeal agreeing on the use of the cost plus method and confirming the inadequacy of the ITA's analysis due to the issues mentioned above considering the OECD principles.

Judgment No 7996 of the Provincial Tax Court of Milan (September 2014)
Judgment No. 7996 concerns the comparability analysis when performing benchmark analysis

The case concerns an Italian company operating in the automotive sector and engaged in assembly and distribution activities. The company purchased goods from related parties. The taxpayer supported its transfer prices for fiscal year 2007 with a benchmark analysis using financial data relating to the period 2004-2006 focused on independent companies with an activity comparable to the activity it performed in 2007.

The ITA performed an alternative benchmark analysis using financial data of years subsequent to 2007 (e.g. 2010). The taxpayer in the recourse challenged that the comparability analysis performed by the ITA was based on the factual situation subsequent to the one year audited as resulted from the use of subsequent financial data and by the fact that the ITA selected companies with an activity comparable to the one performed by the taxpayer at the time when the audit was carried on which was in part different from the activity it performed in the year subject to audit. Moreover, the ITA did not provide any reasons for the rejection of the benchmark analysis performed by the taxpayer.

The Court agreed with the taxpayer's position and stated that a comparability analysis should consider the circumstances in place at the time when the transactions were performed and not on those at the time of the tax audit. Furthermore the Court stated that, according to the OECD principles, loss-making companies should not be excluded automatically as they need to be evaluated on a case by case basis.

Limitation of double taxation and competent authority proceedings
Italy has begun to use the EU Arbitration Convention and has given an impetus to MAPs for intra-EU issues. Based on our experience, the use of the competent authority process to obtain correlative adjustments has not been common in Italy in other circumstances to date. Some aspects of the MAP have been clarified by the Italian Tax Authority in Circular No. 21/E of 5 June 2012.

Some key points of the Circular are:

- It is not possible for an agreement under MAP or the Arbitration Convention to override an Italian court judgment or any negotiated settlement between the Italian tax authorities and an Italian taxpayer. Hence, a court judgment or an out-of-court settlement will preclude any alternative outcome in Italy at competent authority.
- An Italian taxpayer must appeal the tax assessment in order to apply for MAP under a bilateral tax treaty. For an Arbitration Convention procedure to go ahead, however, the taxpayer must be prepared to withdraw from the tax appeals' procedure.
- It is possible to continue with appeals on other matters not covered by MAP or the Arbitration Convention at the same time as embarking on the MAP for TP issues.
- The process for requesting that the collection of tax assessed in Italy be suspended varies between a MAP and the Arbitration Convention. However, the implication is that suspension should be granted in both cases.
- Concerns that the automatic referral in Italy of a tax adjustment above a certain (low) threshold for consideration in the criminal courts constitutes a 'serious penalty' and hence prevents access to the Arbitration Convention are confirmed to be groundless. This should be evaluated on a case-by-case basis.
- If an agreement under a MAP is successfully concluded and the circumstances have not changed, the Circular recognises the possibility of also applying the terms for the years immediately subsequent to those of the MAP.

Advance pricing agreements (APAs)
On 23 July 2004, an official procedure was published for a so-called 'International Ruling', which had been introduced by Article 8 of Law Decree No. 269 of 30 September 2003. This advance ruling is unilateral, although it is also possible to obtain bilateral or multilateral APAs where a DTA has been concluded by Italy and the partner states, based on Article 25, paragraph 3 of the OECD Model Tax Convention on Income and on Capital.

From the latter part of 2010, particularly the ITA has increased the number of instances where a bilateral process with other countries is followed.

The procedure involves companies engaged in 'international activity' and may cover TP, dividends, royalties and interests. Starting from 2014, the scope of the International Ruling procedure is extended also to cases concerning the existence of a PE in Italy.

The following may apply:

- Italian resident enterprises that have transactions that fall under the Italian TP rules and/or entities that are owned by non-resident shareholders or themselves own non-resident entities and/or enterprises that receive or pay dividends' interest or royalties to or from non-Italian persons.
- Any non-resident company carrying on activity in Italy through a PE.

The application for a ruling must be submitted to the competent office. In case of a bilateral or multilateral APA, the application must be submitted to both the International Ruling Office and the International Relations Directorate in the Ministry of Finance. The information to be included in the ruling application, under penalty of non-acceptance, is as follows:

- General information concerning the company, such as the name, its registered office, its tax and VAT identification number, and so on.
- Documentation that proves the eligibility requirements.
- Scope of the application and the purpose of the ruling request.
- The signatures of the legal representatives.

Within 30 days from receipt of the application or from the completion of any inquiry activity, the relevant rulings office may notify the taxpayer to appear to verify the accuracy of the information provided and to define terms and conditions for the subsequent negotiations. The full procedure should be completed within 180 days from the filing of the request, but the parties may agree to extend the deadline.

Once an agreement has been reached, it remains in force for five years (the year in which the agreement is signed and the four following years), according to Article 7 of Law Decree No. 145 of 23 December 2013. There is no formal rollback provision either for years before the application was made or for years subsequent to the application but before the agreement was signed. In case of bilateral or multilateral APA, the possibility to roll back the agreement needs to be checked on a case-by-case basis.

Within 90 days before the expiry of an existing APA agreement, the taxpayer may ask for a renewal. The Revenue Office must approve or decline a renewal at least 15 days before the agreement expires.

Before the beginning of the unilateral, bilateral or multilateral APA procedures, taxpayers may ask the office for some informal clarifications and explanations regarding the procedure (these meetings are called 'pre-filing').

There is no simplified procedure for SMEs.

In 2010, the Italian Revenue Agency issued statistics up to 31 December 2009 and these were updated in a further bulletin issued on 20 March 2013, illustrating the total programme life. They show the APA programme gathering momentum and finding increasing acceptance, with a total of 56 APAs agreed at 31 December 2012 and 54 applications still in process. From 2010, Italy has been prepared to accept applications for bilateral and multilateral APAs, and these represent about 25% of the applications made in each of 2011 and 2012. At the end of 2012, all taxpayers with APAs that had reached expiry had requested a renewal, indicating overall satisfaction with the programme.

Article 7 of Law Decree No. 145 of 23 December 2013 has extended the scope of the International Tax Ruling also to cases concerning the existence of a permanent establishment in Italy.

Italy has implemented a Patent Box regime which entered into force on 1 January 2015 and grants an exemption for Corporate and Regional Tax purposes in respect of income sourced from specified intangible assets. It is being phased in during 2015 and 2016, reaching the final target exemption percentage of 50% by 2017. According to the Italian

Patent Box regime the requirement to enter into an APA is optional for intercompany royalties and probably also for intra-group transfers of ownership. Entering into an APA is mandatory where exemption is sought for a portion of the profit from the sale of goods incorporating R&D.

Liaison with customs authorities
Administrative rules enable the exchange of information between direct tax and customs' authorities, and recent experience suggests that such exchanges do occur (in particular as regards importation of goods from tax haven jurisdictions).

Joint investigations
On 1 May 2006, Italy became the twelfth party to the joint OECD Council of Europe/ OECD Convention on Mutual Assistance in Tax Matters. As a party to the Convention, Italy enhances its ability to combat tax evasion and avoidance through exchange of information on a wide range of taxes.

The Convention has now taken on increasing importance with the G20's call for automatic exchange of information in April 2009 to become the new international tax standard of exchange of information. The Convention provides the ideal instrument to swiftly implement automatic exchange and to ensure that developing countries could benefit from the new more transparent environment

The amended Convention, opened for signature on 1 June 2011, facilitates international cooperation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers. The amended Convention provides for all possible forms of administrative cooperation between states in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion. This cooperation ranges from exchange of information including automatic exchanges, to the recovery of foreign tax claims. Some joint investigations have been carried out.

Online advertising services
Article 1, paragraphs 177–178 of Law no. 147 published in the Official Gazette No. 302 of 27 December 2013, and effective from 1 January 2014, introduced a limitation in the available profit-level indicators that can be used in calculating transfer prices for MNEs that operate in the online advertising sector (literally 'collection of online advertising') or undertake related ancillary activities. Companies can only use cost-based indicators if they reach an APA with the tax authorities on this. This formed part of a package of provisions concerning online business referred to overall as 'Web Tax'.

Applicability of Regional tax (IRAP) to transfer pricing adjustments
Italian corporate taxpayers are subject to two taxes on income – the main corporate income tax (IRES)), charged at a rate of 27.5%, and a regional tax, IRAP (*Imposte Regionale sulle Attività Produttive*), charged at a rate of 3.9%. The applicable base for the two taxes is different.

The rules relating to the definition of the taxable base for the calculation of IRAP were modified with effect from 2008 (Law 244/2007), linking the taxable income for IRAP purposes to the financial statements. Previously, the calculation of the IRAP tax base was linked to that of IRES, which provides for the arm's-length principle. As a result, there was uncertainty as to whether TP adjustments should be subject to regional tax. This uncertainty caused an increase in tax litigation, with taxpayers arguing that

as the tax audit adjustment amounts were not recorded in the company's financial statements, they were not relevant for the purpose of calculating IRAP.

Article 1, paragraph 281 of the 2014 Finance Act clarified that TP adjustments arising on tax audit are relevant for IRAP purposes for fiscal years commencing on, or after, 1 January 2008.

Comparison with OECD Guidelines

The Italian courts have recognised the 1995 Guidelines as persuasive. It is also important to note that in relation to other OECD material (e.g. the OECD Model Treaty Commentary) in three identical decisions relating to a PE case, all in 2006, the Supreme Court limited the role of the OECD Commentary. This was held not to have legislative value but to represent, at the most, a recommendation that may not override local law.

Italy is a member of the OECD and uses the OECD Guidelines in bilateral dealings with other tax authorities. In the absence of detailed and up-to-date local regulations, reference has been often made to the OECD Guidelines by taxpayers, even though the 1980 Ministerial Circular still tends to be a tax auditor's first point of reference.

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Ivory Coast (Côte d'Ivoire)

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Overview

Côte d'Ivoire does not have detailed transfer pricing (TP) regulations. However, some of the provisions of the General Tax Code (GTC) provide for the arm's-length principle. The tax procedure book also provides a non-exhaustive list of documents that could be requested during a tax audit for transactions between related parties.

Country	**Ivory Coast**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No, but documents can be requested during tax audits.
Does TP legislation adopt the OECD Guidelines?	No formal acceptance of the rules.
Does TP legislation apply to cross-border inter-company transactions?	Yes – in terms of anti-avoidance rules
Does TP legislation apply to domestic inter-company transactions?	Yes – in terms of anti-avoidance rules
Does TP legislation adhere to the arm's-length principle?	Yes – in terms of anti-avoidance rules
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	There is no requirement to prepare TP documentation. It could, however, be requested during tax audits.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Ivory Coast (Côte d'Ivoire)

Introduction

Côte d'Ivoire does not have detailed TP guidelines to prevent related parties pricing transactions in a manner that manipulates profits. There are, however, broad anti-avoidance rules that apply to every sector, and for both transactions made by permanent establishments (PEs) locally, as well as those made abroad.

Legislation and guidance

Transfer pricing provisions are provided by both articles 38 of the GTC and 50 bis of the tax procedures book

Pursuant to article 38 of the GTC, for the determination of corporate income tax due by companies depending from companies located outside Côte d'Ivoire, or those controlling the same, profits transferred to the said companies by mark-up or reduction of sale prices, or by any other means, will be added back to the taxable income.

The same treatment applies to companies under the dependence of a company, or a group controlling companies located outside Côte d'Ivoire.

In the absence of precise elements or legislation to determine adjustments, taxable profits are determined in comparison with those of similar companies that are managed normally.

Payments made to related parties should not exceed 5% of the turnover, excluding taxes and 20% of the overheads.

According to article 50 bis of the manual of tax procedures, when the tax authority, in the course of a tax audit, discovers elements that indicate that there may have been an indirect transfer of profits made by the audited company, as per article 38 of the GTC, it can require from this company:

- The nature of the relationships between the local company and the companies located abroad.
- Price determination methods of industrial, commercial, financial and any other kind of operations performed with foreign companies, related evidences and as the case may be, the offered counterparties.
- Activities performed by foreign companies in relation to the above-mentioned operations.
- The fiscal treatment of the operations mentioned in point number 2 above and realised by companies managed outside Côte d'Ivoire, or for those for which the local company is a daughter company or a PE.

Article 50 states that the tax authorities' request should be precise and indicate expressly for each nature of activity or product, the country or the concerned territory, the concerned company and where required, the amounts in question.

Penalties

There are no specific TP penalties in the Ivorian tax provisions. General provisions relating to offences and penalties are fully applicable.

Hereafter is a non-exhaustive list of the penalties applicable under the Ivorian tax provisions:

- *200,000 Communauté financière d'Afrique* (Financial Community of Africa or CFA) francs (XOF) for late submission of corporate income tax (CIT) return for the first month and XOF 50,000 every month thereafter.
- Non-submission of inter alia financial statements, deeds related to changes in articles of incorporation and approval of financial statements attract a XOF 1,000,000 fine for the first month plus an additional XOF 100,000 for each month thereafter till the second month. From the third month, the fine is imposed at XOF 2,000,000 for this third last month plus 200,000 for each month thereafter.
- Failure to account for withholding tax (WHT) on a timely basis will result in interest and penalties. Interest on late payment of tax is levied at 10%, while penalties are levied at 1% for each month or part of the month that the tax remains outstanding.
- Failure to respond to a tax investigation leads to the issue of an estimated tax assessment.
- Tax adjustments identified during the course of a tax audit give rise to late payment interest as well as 100% penalties if the tax authority considers the taxpayer to have acted in bad faith.

Documentation

There are no specific required disclosures/forms describing inter-company transactions.

Nevertheless, it is recommended that companies maintain documentation regarding transactions with foreign-related companies, transfer prices' determination methods, activities made by foreign companies and the tax treatment of transactions with companies located abroad.

However, in the absence of price determination methods pre-approved or at least recommended by the tax authorities, there is no guarantee that this would be accepted.

Even though there is no specific TP documentation, a form (known as Etat 302) is required to be submitted to the tax administration for payments made to all non-employees, both third parties and related parties.

Transfer pricing controversy and dispute resolution

There are no formal pre-validated price determination methods that are approved by the tax administration.

In practice, tax authorities challenge transactions that they judge to not be at arm's length, and request evidence of the operation, as indicated in the guidance section.

The burden of the defence of their arm's-length nature lies on the taxpayer.

Comparison with OECD Guidelines

Côte d'Ivoire is not an Organisation for Economic Co-operation and Development (OECD) member country. OECD Guidelines could serve for preparation of documentation to be shown in case of tax audits.

However, please note that documentation prepared, based on OECD Guidelines, is not binding for the tax authorities.

Ivory Coast (Côte d'Ivoire)

54.
Japan

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Overview

In Japan, transfer pricing (TP) continues to be an area of focus for the National Tax Agency (NTA). In order to increase predictability for taxpayers, over the last couple of years the NTA has worked to further align Japan's TP regulations with the Organisation for Economic Co-operation and Development's (OECD) most recent Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). In addition, the NTA has revised certain directives for interpretation of laws and its own administrative guidelines to further clarify administrative procedures.

Among these changes, the Berry ratio was included as a valid profit level indicator in the Japanese TP legislation from 1 April 2013. Transfer pricing rules were also introduced for the attribution of profits to permanent establishments (PEs) in Japan (effective 1 April 2016), in line with the authorised OECD approach.

The NTA has continued its commitment to mutual agreement procedures (MAPs) and advance pricing agreements (APAs). During the year ended 30 June 2014, the NTA received 152 bilateral APA requests and concluded 141 bilateral APAs.

Country	**Japan**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Is TP legislation consistent with the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Documentation must be submitted to tax authorities on request during an audit

Japan

Country	Japan
Must TP documentation be prepared in the official/local language?	No (but translation may be requested)
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines or other non-monetary penalties for not complying with TP documentation requirements?	No fines, but tax authorities may use secret comparables or conduct taxation by estimation
Are there fines or other non-monetary penalties for branches that do not comply with TP documentation requirements?	As above
How are fines for failure to comply with documentation requirements calculated?	N/A (see above)

Introduction

Japan has had TP legislation in force since 1986, and it was one of the first countries to undertake APAs specifically to cover TP. Japan remains progressive and energetic in its approach to developing TP practice. The Japanese tax authorities have a tremendous amount of experience, and are committing more and more resources to the policing of the TP regime. To date, many significant tax assessments based on TP adjustments have received publicity. As a result, taxpayers should pay careful attention to Japan's TP environment.

Legislation and guidance

Japan enacted formal TP legislation in April 1986 with the Act on Special Measures Concerning Taxation (ASMT) Article 66-4, and since 2005, Article 68-88 for consolidated companies (collectively, Articles 66-4 and 68-88 of the ASMT).
In support of Articles 66-4 and 68-88 of the ASMT, related cabinet orders and ministerial ordinances were issued through the Order for Enforcement of the Act on Special Measures Concerning Taxation Article 39-12 (since 2005, Article 39-112 for consolidated companies; collectively Articles 39-12 and 39-112 of the Cabinet Order of the ASMT) and the Ordinance for Enforcement of the ASMT Article 22-10 (since 2005, Article 22-74 for consolidated companies; collectively Articles 22-10 and 22-74 of the Ministerial Ordinance of the ASMT). The NTA's interpretation and guidance for the application of the TP rules are set out in the related Commissioner's Directives, i.e. Commissioner's Directive on Interpretation of the ASMT Directive and Commissioner's Directive on the Operation of Transfer Pricing (the TP Directive).

Japan's TP legislation, consistent with the OECD Guidelines, is based on the arm's-length principle. Put briefly, Articles 66-4 and 68-88 of the ASMT provide that a corporation (or other juridical person) that has conducted the sale or purchase of inventory, rendered services, or engaged in other transactions with a foreign-related party, must do so at an arm's-length price. In transactions where the Japanese tax authorities determine that arm's-length principles have not been adhered to for the purposes of corporation tax, the price can be adjusted to approximate a third-party transaction. In this situation, under the legislation, the Japanese tax authorities have broad powers to recalculate the transfer price.

Framework of the transfer pricing legislation
In general terms, the legislation applies to international transactions between a 'juridical person' and an affiliated 'foreign juridical person'. As discussed in more detail later, two juridical persons are affiliated when a juridical person is engaged in a transaction with a foreign juridical person with which it has a special relationship.

Applicability
Foreign transactions
In general, the Japanese authorities do not believe that there is a threat of lost tax revenues in domestic transactions because any shifted income is ultimately taxed in Japan. Consequently, Japan's legislation applies only to foreign affiliated transactions. The rules apply between related corporations, regardless of whether the non-Japanese company is the parent or the subsidiary.

Therefore, TP rules do not apply to transactions with a non-Japanese affiliate, where its income is taxable as Japan-sourced income in Japan, due to such affiliate having a PE in Japan.

It should be noted, however, that consistent with the authorised OECD approach to the attribution of profits to PEs, TP rules will apply to internal dealings of foreign corporations to calculate the attribution of income to Japanese PEs from 1 April 2016 (and vice versa to Japanese companies with branches overseas for the purposes of calculating foreign tax credits).

Juridical persons
The legislation applies to cross-border transactions between a juridical person and a foreign juridical person. Juridical persons include corporations, corporations in the public interest such as incorporated associations or foundations, and cooperative associations such as agricultural cooperative associations or small-enterprise cooperative associations. The legislation therefore does not apply to partnerships, unincorporated joint ventures, unincorporated associations or individuals. A foreign juridical person is a juridical entity that is established under the laws of a foreign country and does not have its main office in Japan.

The legislation does not specifically refer to partnership transactions. While it is thought that the legislation does not treat corporate partners as related by reason of their partnership interests, it is believed that certain partnership transactions may be covered if the relationship test is met and the transaction is between Japanese and foreign taxpayers.

Definition of affiliated
Juridical persons are deemed to be affiliated when a juridical person is engaged in a transaction with a foreign juridical person with which it has a special relationship. A special relationship is said to exist:

- if they have a 50% or greater common ownership (*see 50% test section*), and
- if another 'special relationship' exists (*see Other special relationship section*).

The 50% test
The 50% test will be met if the taxpayer, who is a juridical person, directly or indirectly owns 50% or more of:

- the total number of issued shares (voting and non-voting) in the other juridical person, and
- the total amount invested in the other juridical person.

Therefore, the test will be satisfied in the typical case of a Japanese subsidiary of a foreign parent as well as in the case of a foreign subsidiary of a Japanese parent. Two corporations are deemed to be affiliated in instances where, in a brother-sister group, 50% or more of the issued shares (voting and non-voting) in each of the two corporations are owned by the same party. Under the indirect ownership rules, a corporation is deemed to own the stock held by another corporation if the first corporation owns 50% or more of the issued shares of the second corporation. This ownership can be through one corporation or through several corporations. There are no provisions in the Japanese tax law with respect to partnerships. Each partner, however, is generally deemed to personally hold the assets of the partnership. Accordingly, in the case of stock in a corporation, the number of shares deemed held by each partner is proportionate to the partner's ownership in the partnership. Family attribution rules would also apply in determining whether ownership would meet the 50% test. Therefore, in the case of a spouse, any holdings of the spouse are included and, in certain cases, holdings of the spouse's family.

Other special relationship
A special relationship will also exist in situations where the 50% stock ownership test is not met. A special relationship includes situations where:

- 50% or more of the officers of the company are or were employees or officers of the other company (to date no time limit has been specified)
- the representative director of the company is or was an employee or officer of the other company
- a considerable proportion of a company's operating transactions are with the second company (operating transactions are those transactions that are generally related to the corporation's main source of revenue), and
- a considerable proportion of a company's outstanding loans, which are necessary to the company's operations, have been borrowed from or guaranteed by the second company.

Transactions through unaffiliated parties
The Japanese legislation will also apply to transactions entered into with unaffiliated persons in cases where the transactions with the foreign affiliates are conducted through an unaffiliated person (presumably acting as a conduit). This rule is designed to address transactions that take place with an unrelated trading company. Trading companies in Japan play a vital role in facilitating the import and export of goods. They act as an intermediary between the seller and the purchaser of the goods in question. Some commentators believe this provision was necessary because in Japan a substantial portion of the import/export business is conducted through trading companies.

Types of transactions covered
The legislation covers transactions involving the sale or purchase of tangible personal property and other transactions. The legislation was deliberately left quite broad to give the NTA a greater degree of flexibility. The types of transactions falling within the other transactions category include:

- Rents from tangible assets.
- Royalties for the use of and consideration for the sale or purchase of intangible assets.
- Interest on loans or advances.
- Fees for inter-company services.

The legislation sets out detailed rules for transactions involving tangible personal property and requires the use of equivalent methods for other transactions. It should be noted that the Japanese reporting form (Schedule 17(4) for taxpayers with fiscal years ending on, or after, 1 April 2009, formerly Schedule 17(3)), which is part of a corporation's annual tax return, includes requests for information regarding these other transactions (*see Tax audits section*).

Methods of arm's-length price determination
The legislation provides that the affiliated juridical persons must conduct their transactions at an arm's-length price. While the legislation does not specifically recognise either a range of arm's-length prices or net profitability as a standard for establishing specific arm's-length prices, the range concept is incorporated in the ASMT Directive and TP Directive. The ASMT Directive provides that no TP assessment shall be issued if the taxpayer's price or profitability falls within the range earned by several comparable transactions with a high level of comparability. In addition, the TP Directive provides that in determining the arm's-length price for the purpose of issuing an assessment, the average of those transactions may be used if the price/profitability of the tested transaction falls outside the range.

The sale or purchase of inventory
The legislation provides specific methods for determining an appropriate arm's-length price. It provides that the arm's-length price should be determined, in the case of the sale or purchase of inventory, under:

- the comparable uncontrolled price (CUP) method
- the resale price method (RPM)
- the cost plus (CP) method
- method similar to the above methods, and
- other methods.

Until the 2011 tax reform, only if the CUP, RPM or CP methods could not be used, a method similar to one of them, or other methods prescribed by Articles 39-12 and 39-112 of the Cabinet Order of the ASMT could be applied. However, under the 2011 tax reform this priority rule was abolished and instead the so-called best method rule was introduced for business years beginning on, and after, 1 October 2011.

The other methods
Articles 39-12 and 39-112 of the Cabinet Order of the ASMT in effect introduce the profit split method (PSM) and the transactional net margin method (TNMM) as other methods.

Three types of PSM are allowed (paragraph 8(i)), i.e. the comparable profit split method (CPSM), the contribution profit split method and the residual profit split method (RPSM):

- The CPSM distributes the profit to the parties by reference to the profit split ratio of a comparable transaction between unrelated parties where such information is available.
- The contribution profit split method requires profits to be allocated between enterprises based on factors illustrating the degree to which each party contributed to the realisation of income, such as the amount of expenses incurred or the values of fixed assets used.
- The RPSM may be applied when either party to the controlled transaction owns significant intangible assets. In this method, routine profits are first distributed to the respective parties by reference to the information of the uncontrolled transaction without having significant intangible assets. The residual profit is then distributed to the respective parties in proportion to the value, or the costs incurred for the development, of the significant intangible assets that they own.

The TNMM as described in Articles 39-12 and 39-112 of the Cabinet Order of the ASMT provides four ways by which arm's-length pricing may be determined:

- TNMM by return on sales (paragraph 8(ii)) computes the transfer price in a controlled transaction as the tested party's resale price minus the sum of:
  - the tested party's resale price multiplied by the operating margin of the comparable transaction, and
  - the tested party's selling, general and administrative expenses.
- TNMM by full cost mark-up (paragraph 8(iii)) computes the transfer price in a controlled transaction as the sum of:
  - the tested party's total costs, being the sum of costs of goods sold and selling, general and administrative expenses, and
  - the tested party's total costs multiplied by the full cost mark-up of the comparable transaction, i.e. the ratio of operating profit to total costs of the comparable transaction.
- TNMM by the ratio of gross profit to selling, general and administrative expenses (i.e. the Berry ratio) computes the transfer price in a controlled transaction as:
  - the tested party's resale price minus the tested party's selling, general and administrative expenses multiplied by the ratio of gross profit to selling, general and administrative expenses of the comparable transaction (paragraph 8(iv)), or
  - the tested party's cost of goods sold plus the tested party's selling, general and administrative expenses multiplied by the ratio of gross profit to selling, general and administrative expenses of the comparable transaction (paragraph 8(v)).

Under paragraph 8(vi), the transfer price in a controlled transaction may also be computed by reference to a method similar to those described under paragraphs 8(i) to 8(v).

Other transactions

For transactions other than the sale or purchase of inventory (such as rent for the use of tangible property, royalties for the use of, or consideration for, the sale or purchase of intangible property, services rendered and interest on loans or advances) the legislation provides that methods equivalent to the CUP, RPM, CP method, PSM and TNMM can be used.

Moreover, for inter-company services, the TP Directive includes specific reference to the treatment of intragroup services, largely as a reiteration of the OECD commentary on intragroup services (Chapter VII, OECD Guidelines). Payment for such services is deductible by the recipient company if the recipient would need to acquire the services from an unrelated party, or perform them itself, if they were not provided by the related party. However, services provided by a parent company in its capacity as shareholder are not treated as services performed for consideration and are not deductible. This treatment applies equally to both Japanese parent and foreign parent multinational companies. In addition, the TP Directive contains a provision enabling the tax examiners to treat payments for inter-company services that cannot be supported by the Japanese payer as non-deductible donation expenses under the domestic tax legislation, rather than as a matter of TP under Articles 66-4 and 68-88 of the ASMT. It is the NTA's position that taxpayers subject to an adjustment to taxable income under the domestic tax legislation are not entitled to relief through MAPs, even if double taxation occurs as a result.

The TP Directive also prescribes guidance on the appropriate treatment of cost contribution arrangements (CCAs) and transactions involving intangible property.

Penalties

There is an automatic penalty of 10% of additionally assessed taxes, plus 5% of additionally assessed taxes exceeding the amount higher of taxes originally reported or 500,000 Japanese yen (JPY). However, a 35% penalty is imposed on understatements where deliberate tax evasion is judged to have taken place. These penalties are not deductible for corporation tax purposes.

In addition, interest is charged on additionally assessed taxes as follows:

- For periods prior to 1 January 2014, at the lower of 7.3% per annum or the sum of the basic discount rate and basic loan rate (previously known as the official discount rate) as of 30 November of the previous year (0.3% as of 30 November 2013) plus 4% (i.e. a total of 4.3% for 2014).
- For periods after 31 December 2013, at the lower of 7.3% per annum or the sum of the rate announced by the Minister of Finance by 15 December of the previous year (e.g. 0.8% for 2015, as announced on 12 December 2014) plus 2% (i.e. a total of 2.8% for 2015).

The above rates are applied for one year after the due date for filing, and for the period from the issuance of the notice of assessment until the date on which the additional tax is actually paid. If unpaid tax is not subsequently paid within three months of the date that a notice of assessment is issued, the interest rate increases to:

- For periods prior to 1 January 2014, 14.6% per annum.
- For periods after 31 December 2013, the lower of 14.6% per annum or the sum of the rate announced by the Minister of Finance by 15 December of the previous year (e.g. 0.8% for 2015, as announced on 12 December 2014) plus 8.3% (i.e. a total of 9.1% for 2015).

The above interest is statutory interest, and is not deductible for corporation tax purposes.

Effective 1 April 2007, in the event that a taxpayer files a request for MAPs following a TP assessment, payment of national tax and penalties pertaining to the assessment can be deferred until the completion of MAPs (one month after the day following the date of reassessment based on mutual agreement, or should agreement not be reached, one month from the day following the notification of this fact to the taxpayer), if requested by the taxpayer. In addition, the taxpayer is exempted from delinquent tax for the deferral period. The taxpayer, however, needs to provide collateral for the amount of taxes to be deferred. The same deferral system for local taxes was introduced in 2008.

Documentation

While there is no contemporaneous documentation rule in Japan (and it is not necessary to file TP documentation together with a company's corporate tax return), in an audit, the tax authorities are entitled to request any information they consider necessary to determine the appropriate transfer price.

A list of documents that may be requested to be presented or submitted during a TP audit was incorporated into the Japanese TP legislation as part of the 31 March 2010 legislative revisions (under the 2010 Tax Reform). Two categories of documents are now required to be presented or submitted during a TP audit. These are:

- Documents providing details of the taxpayer's foreign affiliated transactions.
- Documents used by the taxpayer for the calculation of arm's-length prices.

The specified information is essentially the same as that contained in a typical TP report.

Prior to this amendment, there was no explanation of what documents were required to be presented or submitted during an audit under the Japanese legislation (although a similar list of documentation was contained in the TP Directive). Now, a more detailed list of the documents contained in each category is formally provided in Articles 22-10 and 22-74 of the Ministerial Ordinance of the ASMT. Among others, these include the books of account, records and other documents, not only of the taxpayer but also of the foreign affiliate. As to requests for overseas information, the taxpayer is required to endeavour to meet such requests.

If a taxpayer fails to submit the requested information within a reasonable period of time, the tax authorities may exercise their power to use secret comparables or conduct taxation by estimation (*see Tax audits section*).

Transfer pricing controversy and dispute resolution

Burden of proof

The Japanese legal system places the burden of proof in all taxation matters with the Government. Transfer pricing examiners consider that this requires them to obtain detailed information regarding comparable transactions, although they also believe that generally, such information cannot be disclosed to a taxpayer, as this is prohibited by taxpayer confidentiality requirements. This situation gives rise to the issue of so-called secret comparables (*see Use and availability of comparable information section*). In practice, in any audit, the taxpayer has a clear burden under the legislation to provide information and, in any case, as a matter of examination management strategy, it could be potentially disadvantageous to withhold information.

Tax audits

Risk review

Companies are required to complete and return an annual corporation tax return. As part of that return, Schedule 17(4) must be completed; this gives details of the taxpayer's foreign affiliated parties and any transactions with those parties including disclosure of the TP methodology adopted for each transaction. A review of this form, in conjunction with the company's financial statements and a review of the company's results, may lead the tax authorities to select a company for audit.

Within the context of this review, the NTA is likely to be alerted to the possibility of TP issues in cases where:

- the volume of transactions with affiliated foreign companies is notably large
- inter-company prices, commissions paid and royalty rates charged are set but later changed so that related foreign parties receive advantages or benefits
- a company's profit does not increase in proportion to expansion in the market for its principal product or is not in proportion to the taxable income of comparable companies
- losses are made on the sale of products purchased from affiliated foreign companies
- affiliated foreign companies are making profits that do not reflect the functions they perform
- the functions performed by affiliated foreign companies are not clearly identified
- the basis on which royalty rates have been calculated is not identified, and
- the basis on which income is allocated between the company and affiliated foreign parties appears to be unreasonable.

The likelihood of a TP audit is the same for domestic or for foreign-owned companies.

Audit procedures
While TP has typically been examined separately to general corporation tax, following the clarification of certain audit procedures (effective 1 January 2013), TP is now covered by, and can be reviewed during, general corporation tax audits (unless taxpayers approve to separate TP and general corporation tax audits). In addition, when commencing an audit, the tax authorities should in principle provide the taxpayer with a formal notice of examination. The notice should include information on the purpose of the examination, the tax type and the taxable period to be covered by the audit.

Once an audit has commenced, examiners from the appropriate Regional Tax Bureau (RTB) or tax office visit the taxpayer's premises to conduct an investigation. The tax authorities are entitled to request any information they consider necessary to determine the appropriate transfer price including (i) documents providing details of the taxpayer's foreign affiliated transactions, and (ii) documents used by the taxpayer for the calculation of arm's-length prices (*see Documentation section*). If a taxpayer fails to present or submit the documents requested in an audit (including overseas information that is recognised to be necessary to determine an arm's-length price) within a reasonable period of time, the tax examiners may exercise their power to use secret comparables (*see Use and availability of comparable information section*) or to conduct taxation by estimation (*see Taxation by estimation section*). In addition, in order to provide clarification of the factors that should be taken into account when examiners are investigating the negotiation of transfer prices between affiliated parties, the TP Directive highlights the facts that:

- taxpayers may in fact use arm's-length principles to determine their transfer prices, in order to properly assess both their own financial performance for the business relating to the inter-company transactions, and that of their affiliated party, and
- in some cases, such as joint ventures, third parties (i.e. shareholders of a joint venture) may be involved in the negotiation of transfer prices between two affiliated parties, taking into account arm's-length principles.

The 22 June 2010 amendment goes on to specify that the tax authorities should consider not only the profitability of the two affiliated parties engaged in any inter-company transaction, but also the above-noted negotiation procedures conducted in deriving the transfer price for that inter-company transaction. That is, where a transaction is conducted between a taxpayer and a joint venture owned equally by that taxpayer and a third party, the transaction is subject to the Japanese TP legislation; however, if the transfer price for that transaction is determined by negotiation with the third-party investor taking into account arm's-length principles, the transfer price may well be accepted as being at arm's length.

When concluding a tax audit, if the tax authorities do not consider that an assessment should be made, the authorities should notify the taxpayer accordingly in writing. If the tax authorities consider that an assessment should be made, they shall provide the taxpayer with information on the results of the examination. The tax authorities may only conduct a re-examination 'when it is regarded that there is an error in light of newly-available information' with respect to a taxable period on which the tax authorities have already concluded an examination. In other words, once an audit is complete, those years are closed to further review so long as no new information comes to light that would have otherwise affected the result of that audit.

Use and availability of comparable information

The Japanese tax authorities' very strict compliance with the legislation leads the auditors to review TP on an individual transaction basis (or product line basis or business segment basis), with a strong focus on the profitability of both affiliates involved in a transaction. While the TP Directive issued by the NTA refers to the operating profit margin in the context of an irregularity check, the NTA's and RTB's historical preference for profit split analyses remains unchanged where such is used either as a TP methodology itself or as a reasonableness check of the method used by the taxpayer, depending on the situation. However, when it is not possible to conduct a profit split analysis because of a lack of financial data about the foreign affiliate, the examiners generally revert to gross or operating profit margins to establish arm's-length prices.

Given the tax authorities' practice of reviewing transfer prices on an individual transaction basis, they place heavy reliance on comparable transactions. In the past, these were external uncontrolled comparable transactions obtained by reverse audit of the taxpayer's competitors (i.e. secret comparables). However, the use of secret comparables is very restricted these days. The TP Directive requires examiners to provide the taxpayer with an explanation of conditions of selection of the secret comparables, the content of the comparable transactions, and the method of adjustment for any differences between those transactions and the taxpayer. However, the scope of such explanation is restricted by a confidentiality requirement placed on examiners, and so the identity of the secret comparables remains undisclosed and can create major difficulties at audit.

Taxation by estimation

If a taxpayer fails to present or submit the documents requested in an audit within a reasonable period of time, the tax examiners may exercise their power to use taxation by estimation. Taxation by estimation allows the tax examiners to estimate transfer prices without reference to the taxpayer's own TP method (including based on transactions between affiliated parties, so in theory not at arm's length). In addition, the authorities may estimate taxable income to the Japanese company on its cross-border transaction with a foreign affiliate by applying one of certain prescribed methods. The prescribed methods include either the RPM, the CP method, or a PSM using a high-level global profit split (i.e. based on an allocation of the total consolidated operating margin of the entire group to which the taxpayer belongs, as disclosed in the group's annual report, assuming that a segmented consolidated operating margin including the transactions under audit is not provided in the annual report). However, taxation by estimation is a last resort for the tax authorities, and to date there has reportedly been only one case where it has been applied.

Recourse options

There are three domestic methods and one bilateral method of recourse for tax relief available to taxpayers upon receiving a notice of assessment:

- Domestic recourse:
  - Request for reinvestigation to the applicable RTB or tax office.
  - Request for reconsideration to the National Tax Tribunal.
  - Litigation.
- Bilateral recourse under the Japan/Treaty Partner Nation Tax Convention (competent authority negotiations or arbitration).

Recourses available to the tax authorities
Tokyo, Osaka and several other RTBs each have a team of specialist TP examiners who conduct investigations. Over the past several years, the NTA has increased its TP enforcement by monitoring and expanding the scope of its examinations. The NTA has been increasing the number of examiner positions and the number of offices to be used to investigate TP strategies in order to handle the increase in the number of TP cases and APA requests (*see Advance pricing agreements section*). Additionally, the NTA is educating its staff to identify red-flag issues to consider when auditing corporations that are operating in Japan. As the NTA has become tougher, more experienced and sophisticated in TP, it has made some very large assessments against a number of companies in various industries including the pharmaceutical and medical equipment industries.

Limitation of double taxation and competent authority negotiations/arbitration
All tax treaties concluded by Japan contain a provision for competent authority negotiations. The Deputy Commissioner (International Affairs) of the NTA, who head the NTA's Office of International Operations and Office of Mutual Agreement Procedures, are in charge of competent authority negotiations. Since mid-2010, tax treaties concluded by Japan have also contained provisions for arbitration, where competent authority negotiations are not concluded within a two-year period.

If competent authority negotiations or arbitration result in the Japanese authorities having to cancel a portion of a proposed TP adjustment, the RTB will reduce the amount of tax due accordingly (i.e. the taxpayer does not need to file for a reassessment of tax). Such reductions will have a corresponding effect on the amount of local taxes due, since municipal and prefectural taxes are based on the amount of corporation tax paid.

As of 30 June 2013, there were 339 ongoing cases under competent authority negotiation (for both TP assessment and APA cases) and it is anticipated that the number of cases will continue to increase. One of the major reasons for difficulties in competent authority negotiations is the difference in tax policies relating to the methodology that should be used in determining an appropriate arm's-length price. For example, as was evident in the bilateral US–Japan APA reportedly obtained by Komatsu, Ltd., it is understood the US IRS preferred to use the comparable profits method (CPM) while the NTA preferred to use a PSM, especially given a Japanese multinational was involved.

No cases have been taken to arbitration in Japan as yet.

Advance pricing agreements (APAs)
The original Japanese APA system was called the pre-confirmation system (PCS) and was instituted in April 1987, immediately following the introduction of TP legislation. Japan was one of the first countries to introduce such a system solely for TP purposes.

A significant body of APA experience has developed since then, and in October 1999, the NTA issued a formal directive on APA procedures, which in large measure brought existing practice onto a more formal basis. That directive has since been integrated into the TP Directive.

Under the TP Directive, there is a strong expectation that an APA will be bilateral. Under an APA, a taxpayer submits its transfer pricing methodology (TPM) to be used to determine the arm's-length price and its specific content (together, the TPM) to the relevant RTB. The RTB will evaluate the TPM and, if appropriate, confirm it or suggest changes. As part of this process, if the APA is bilateral, coordination through the NTA's Office of Mutual Agreement Procedures will arrive at competent authority agreement. Once a TPM is agreed upon (as long as tax returns comply with the agreed TPM), pricing is regarded by the RTB as arm's length. In principle, the period to be covered by an APA is three to five years.

The TP Directive recognises pre-filing conferences as an important part of the APA process. In addition, the formal filing requires a body of detailed supporting documentation including a functional analysis, details of the TP methodology applied for, standalone financial statements of the taxpayer as well as its foreign affiliate that is party to the transaction subject to the APA application, and an explanation of the material business and economic conditions assumed. An amendment (effective 25 June 2007) to the TP Directive also strengthened the wording of the application requirements. As a result, the inclusion of the standalone financial statement of the foreign affiliate into the APA application is a strict requirement to be adhered by the taxpayer, and non-submission may result in the RTB's refusal to process the APA application. Moreover, the same amendment also provides that an APA application may not be processed if it results in profit in Japan being reduced without reasonable economic grounds.

An APA application will not stop an ongoing TP audit, although there is specific clarification that roll-back – the use of an agreed TPM for periods prior to an APA being in force – may be acceptable for bilateral or multilateral APAs. There is also guidance relating to post-year-end adjustments to conform to a TPM.

Between 1987 and 1992, few PCS cases were filed and only a handful of these were approved. Since 1992, however, TP legislation around the world (particularly in the United States) has developed considerably. In response to this, the NTA has taken an even more proactive attitude towards the bilateral APA procedures. Between 30 June 1999 and 30 June 2014, some 1,449 bilateral APA applications had been filed, with more than 1,189 APAs completed during the same period. In addition, the number of APA examiners at the Tokyo RTB has continued to increase, from 27 in 2007 to 54 in 2014. Examples of reported APAs include:

- Apple Computer Japan, Inc. was the first foreign parent company to obtain a bilateral APA with the NTA and IRS. It was reported that the profit ratios from domestic sales of Apple's personal computers were to be based on ratios that were mutually agreed to by the NTA and the IRS.
- Matsushita Electric Industrial Co. became the first Japanese-parent taxpayer to obtain an APA with the NTA and IRS.

Legal cases

Court cases

On 30 October 2008, the first court case on the application of Articles 66-4 and 68-88 of the ASMT was won by the taxpayer on appeal to the Tokyo High Court (the decision at first instance was issued by the Tokyo District Court on 7 December 2007). The basis for the High Court's decision related primarily to the selection of TP methodology and the issue of comparability. The NTA's use of secret comparables, which was upheld by the Tokyo District Court, was not addressed by the Tokyo High Court (*see Use and availability of comparable information section*). The NTA abandoned its right to appeal the decision of the Tokyo High Court.

Tribunal cases

On 2 February 2010, TDK announced that the National Tax Tribunal had reduced a determination made by the Tokyo RTB against the company in 2006 arising from electronic parts transactions with foreign affiliates in Hong Kong and the Philippines. As it is extremely rare for a taxpayer to succeed in an appeal to the National Tax Tribunal on purely TP grounds, this result was interesting in itself. In addition, the size of the reduction made by the National Tax Tribunal in favour of TDK was also significant. In fact, it is understood that the National Tax Tribunal reduced the originally assessed amount of JPY 21.3 billion by about JPY 14.1 billion.

Comparison with OECD Guidelines

Japan is a member of the OECD and actively participated in drafting the 1995 OECD Guidelines including the 2010 revisions. As such, the NTA generally supports the theory and practices set out in the OECD Guidelines, as confirmed by the TP Directive and in amendments to the TP legislation under various tax reforms. In practice, however, the OECD Guidelines are interpreted and implemented within the framework of Japan's own TP legislation, as well as Japan's unique political and economic context. This localisation of OECD principles has historically created some differences in the implementation of the OECD Guidelines in Japan compared with other jurisdictions, although such differences have lessened over time as a result of Japan's extensive competent authority experiences with other OECD jurisdictions. Nevertheless, Japan's TP legislation, consistent with the OECD Guidelines, is based on the arm's-length principle.

55.
Jordan

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Overview

Jordan does not currently have specific transfer pricing (TP) regulations and guidelines; however, the new Income Tax Law (effective since 1 January 2010) has introduced a general anti-avoidance rule (GAAR). Like many Middle Eastern countries, Jordan has a relatively low corporate tax rate of 20%.

Country	**Jordan**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	
When must TP documentation be prepared?	No statutory TP documentation requirements
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes

Jordan

Country	Jordan
How are penalties calculated?	Delay fine at a rate of 0.4% of the value of the tax due. Shortage fee for differences will be imposed, as follows: 15% of the shortage if the difference exceeds 20% but less than 50% of the tax due by law 80% of the shortage if the difference exceeds 50% of the tax due by law.

Introduction

The new Income Tax Law (effective since 1 January 2010) has introduced a GAAR. According to this GAAR, the competent authorities are allowed to adjust transactions that are considered not to be conducted according to the arm's-length principle.

Legislation and guidance

Any transaction which is not based on the arm's-length principle, and is between parties that have mutual interests, and leads to a decrease in the taxable income is ignored, and real taxable profits are estimated according to the regular market value of the transactions (Article 20 section e, Income Tax Law).

Any illusionary or fake transactions are ignored and the tax due is estimated as if there were no transactions (Article 20 section f, Income Tax Law).

Penalties

In case of failure to pay or remit the tax on the specified dates according to the provisions of the Income Tax Law, the competent authorities may impose a late payment fine at the rate of 0.04% of the due tax or any amounts that must be remitted or withheld for each week of delay or any part of it.

If the taxpayer filed their tax declaration and paid the tax within the specified date and then has had to pay any tax differences according to the provisions of the Income Tax Law, then the late payment fine on this difference according to the previous paragraph shall not exceed 35% of the difference amount.

If it is proved that there is missing information in the submitted tax declaration by the taxpayer, a legal compensation shall be imposed with the following rates:

- 15% if the difference is more than 20% and does not exceed 50% of the due tax
- 80% of the tax difference if it exceeds 50% of the due tax.

Documentation

A taxpayer is required to prepare the necessary books and records to compute their due tax, provided that it shall be prepared in accordance with international accounting standards and audited and certified by a CPA and they are required to hold these records for four years, starting from the later of any of the following dates:

- end of tax period date in which the records and books were prepared
- tax declaration filing date, or
- the date of notifying the taxpayer with the result of the administrative assessment decision.

In case there is a conflict or disagreement on their due tax amount and any other related amounts and fines, the taxpayer is required to hold their books and records until the conflict is settled or a final decision is issued by the court, provided that it shall be consistent with the provisions of Income Tax Law.

A taxpayer may prepare and hold their records and books in English, provided that they shall provide an Arabic translation if the tax authority requests. In cases where a taxpayer has not prepared the necessary records and books according to what is required, the instructions shall specify the total or net profits for goods, merchandise or services dealt by commercial, industrial, or service sectors and these rates shall be considered a legal presumption.

Transfer pricing controversy and dispute resolution

Given the absence of TP guidelines with specific TP provisions (including delineation of specified TP methods), there are no specific rules regarding burden of proof.

Comparison with OECD Guidelines

Although Jordan is not an Organisation for Economic Co-operation and Development (OECD) member, it acknowledges the importance of the OECD Guidelines as the international best practice.

Jordan

56.

Kazakhstan, Republic of

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Overview

Historically, Kazakh legislation on transfer pricing (TP), as well as the tax audits and court cases, has been aimed at pricing of commodities. However, in recent years the focus extended to other transactions, such as provision of services and loan transactions. Tax audits start to put more resources to TP-related matters.

Country	**Kazakhstan**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Only if those are related to cross-border transactions under certain circumstances.
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	In certain cases
When must TP documentation be prepared?	TP documentation should be maintained for all transactions subject to TP control. However, it should be presented to the tax authorities upon their request (within 90 days).
Must TP documentation be prepared in the official/local language?	It can be maintained in any language, but should be presented to the tax authorities in official/local language.

Kazakhstan, Republic of

Country	Kazakhstan
Are related-party transactions required to be disclosed on the tax return?	No. However, large taxpayers are required to submit monitoring reports on certain transactions, subject to monitoring, which includes information about relationships between parties.
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes, if additional income is assessed
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Administrative fine in the amount of up to 50% of underpaid tax, as well as late interest charges.

Introduction

Kazakhstan adopted a separate law concerning TP (which included the arm's-length concept), which came into effect on 1 January 2009.

This law has become the subject of much attention from both local and foreign companies operating in Kazakhstan. This attention stems mainly from the fact that the TP law, in certain aspects, significantly departs from the key principles outlined in the Organisation for Economic Co-operation and Development (OECD) Guidelines. As a result, the TP law and corresponding rules contain a number of unusual concepts, some of which have the effect of widening the scope of the application of TP by the auditing authorities.

Additionally, TP law and rules contain a number of ambiguous provisions, which impact the practice of how the authorities apply the law.

Legislation and guidance

Scope

While the TP law focuses on cross-border transactions, it remains extremely broad in scope, primarily because TP control extends to certain transactions involving unrelated parties. As a result, competent state authorities (i.e. tax and customs) are empowered to execute control over prices applied for all cross-border transactions of the taxpayers including between related and unrelated parties.

The control also may be carried out in respect of domestic transactions within Kazakhstan, if they are directly related with international business transactions and one of the following conditions is met:

- Minerals are sold by a subsoil user.
- One of the parties applies certain tax benefits.
- One of the parties declared tax losses for the two most recent tax periods preceding the year of the transaction.

The law is accompanied by six decrees with additional information on:

- list of goods and services subject to monitoring
- list of officially-recognised sources of pricing information
- rules on conclusion of advance pricing agreements (APAs)
- rules on pricing for natural uranium concentrate
- rules on pricing for titanium and magnesium products, and
- rules on the interactions between competent authorities regarding execution of TP control.

Related parties
The TP law generally defines related parties as individuals or legal entities whose mutual relations may allow the economic results of the transactions to be influenced. The law further sets out a comprehensive, non-exhaustive list of 15 scenarios that would result in parties being deemed as related for the purpose of the TP law. Under the list there is a scenario that states:

'When parties to a transaction apply a price that deviates from market price determined based on a range of prices according to the data of one of the authorised bodies', such transactions could be treated as those performed between related parties.

Therefore, this provision allows the Kazakh authorities to treat any transaction as a related-party transaction, based on their set of market prices.

Pricing methods
For determining market prices, there is a hierarchical order of five TP methods:

- Comparable uncontrolled price method (CUP)
- Cost plus method.
- Resale price method
- Profit split method.
- Transactional net margin method.

Formally, only in cases where it is impossible to apply the CUP method, one of the other four methods should be used sequentially.

Other regulations
Also, Kazakhstan introduced rules for monitoring of transactions. According to these rules, certain taxpayers involved in inter-company transactions should submit a specific TP monitoring report by 15 May following the financial year when the controlled transactions took place. There are two conditions for this requirement:

- A taxpayer should be included in the list of the 300 largest taxpayers established by the Government.
- The type of transaction is included in the list of goods and services subject to monitoring (e.g. oil and gas products, marketing services) established by the Government.

Control approach of the tax authorities

Competent authorities carry out TP control using the following means:

- Monitoring of certain transactions (i.e. gathering detailed information on the sale/purchase of certain goods and services).
- Carrying out TP audits.
- Enquiries to the parties of the transaction, any third parties directly or indirectly involved in the transaction as well as the competent authorities of the other jurisdictions involved.

The customs' authorities maintain databases on export/import prices of goods and services, and provide this information to the tax authorities on a monthly basis.

Risk transactions or industries

Based on practical experience, the highest risk transactions from a TP perspective involve subsurface-use operations (i.e. export of oil and other commodities) and financial services.

Moreover, management services are subject to scrutiny. However, we have not seen large TP adjustments with respect to management services, since the Kazakh tax authorities had limited experience in evaluating the pricing of services and intangibles. However, the situation is evolving.

Anticipated developments in law and practice

The government appears willing to further develop TP legislation. Anticipated changes include:

- Exclusion of separate monitoring reports for large taxpayers (such information will form a part of corporate income tax return).
- Cancellation of hierarchy of TP methods – clear priority is given only to CUP and in case CUP is not applicable, any of the remaining four methods can be applied.
- Exclusion of transactions between unrelated parties from the TP control. This will be implemented only if general anti-avoidance provisions will be introduced.

Liaison with customs' authorities

Both tax and customs' authorities are currently acting under one umbrella of State Revenue Committee, and should coordinate with each other on TP matters.

In particular, the customs' authorities maintain an electronic database of customs' declarations and provide the tax authorities with information on goods and services that are subject to monitoring.

Thin capitalisation

The tax authorities pay attention to the interest rate during corporate income tax reviews. Transfer pricing control is used in addition to the debt-to-equity ratio limitations established in the tax legislation.

Penalties

As a result of the application of the TP provisions, the tax authorities may adjust prices leading to the assessment of additional taxes including corporate income tax, value-added tax, excise and excess profits tax for subsurface users, and customs' payments.

The Code of Kazakhstan on Administrative Violations does not provide for specific fines for the violation of TP legislation. Typically, taxpayers are penalised, based on the provision for underreporting taxes in tax returns with an administrative fine up to 50% of the additionally assessed tax.

Penalty interest at the annual rate of 13.75% (currently) is imposed on a daily basis for each day of delay of the tax payment.

Documentation

The Kazakh TP law sets out formal TP documentation requirements for transactions subject to TP monitoring. However, in practice, the same information is expected to be included into TP documentation for all other controlled transactions:

- Industry analysis.
- Group structure/relevant relationships.
- Functions and risks' analysis.
- Information on the inter-company transactions.
- Description of pricing method applied.
- Financial analysis.
- Comparability analysis including details of the official sources of information used.
- Other relevant information for substantiating the arm's-length nature of the prices applied.

The taxpayers must submit the documentation within 90 days upon the tax authorities' request.

Transfer pricing controversy and dispute resolution

Legal cases

The most significant court cases on TP matters involved appeals of subsurface users to the tax authorities' TP adjustments in relation to the export of oil and other commodities.

Burden of proof

Generally, the transaction price is deemed to be the market price unless proved otherwise by the tax authorities. However, in practice, it is often the case that the burden of proof is shifted to the taxpayer to demonstrate that the price was market.

Tax audit procedures

Transfer pricing matters are normally covered within the scope of regular tax audits. However, separate TP-focused tax audits may also be carried out for the same periods.

The tax authorities also have a right to request the taxpayers to substantiate the 'arm's-length' pricing of certain transactions. If the taxpayer does not provide sufficient documentation to support its position the tax authorities may initiate a tax inspection.

Revised assessments and the appeals' procedure

Taxpayers have the right to appeal the TP adjustments to the higher level tax authority, up to the State Revenue Committee of the Ministry of Finance. If the appeals to the tax authorities fail, taxpayers may further appeal the assessments in Kazakh courts (taxpayers have the right to appeal directly to courts as well).

Joint investigations
The Kazakh tax authorities may conduct joint investigations on TP matters with other members of the Eurasian Economic Community.

The Kazakh tax authorities may also request information on TP from the competent authorities of other states with which Kazakhstan has signed double tax treaties (DTT) (currently 47 states).

Advance pricing agreement (APA)
In February 2009, Kazakhstan introduced APA rules. These rules determine the procedures and documents required for application to the Kazakh tax authorities for APAs.

The tax authorities have the right to review the taxpayer's documents for up to 60 business days within the APA approval process. An APA could be concluded for the term up to three years.

Comparison with OECD Guidelines
Kazakhstan is not a member of the OECD, and Kazakh tax and custom's authorities are not bound by OECD Guidelines on TP. Given the limited TP provisions in domestic legislation, the tax authorities might unofficially refer to the OECD Guidelines for guidance.

Limitation of double taxation and competent authority proceedings
Although the majority of DTTs concluded by Kazakhstan contain provisions on competent authority proceedings, the Kazakh tax authorities have not applied them frequently in practice. As Kazakh TP legislation departs from the OECD Guidelines in various areas, this makes competent authority proceedings difficult.

57.

Kenya

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Overview

The Kenya Revenue Authority (KRA) takes a rigorous approach to audits and regularly requests transfer pricing (TP) documentation from taxpayers with cross-border related-party transactions with the intention of risk profiling them for the purpose of conducting TP audits. Having identified some weaknesses in the current TP rules, the KRA is proposing to issue new TP rules in the next year.

Country	**Kenya**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	On request from the Commissioner the taxpayer is required to submit the TP documentation.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	20% of principal tax

Kenya

Introduction

Kenya has always had a general provision within its tax legislation requiring transactions between non-resident and resident-related parties to be conducted at arm's length. However, until 2006, no guidance had been provided by the KRA on how the arm's-length standard was to be met. This failure to provide guidance led to protracted disputes between taxpayers and the KRA, culminating in a landmark case involving the Commissioner of Income Tax and Unilever Kenya Limited (the Unilever case). The judgment of the High Court in the Unilever case led to the introduction of TP rules in July 2006, which provide guidance on the application of the arm's-length principle. The KRA intends to introduce Practice Notes to assist taxpayers in their review of their TP policies

In addition to the lack of guidance, Kenya has no procedures in place by which a taxpayer might achieve an advance pricing agreement (APA) to its TP policy. In general terms, the KRA is reluctant to give binding rulings regarding practices or policies adopted by a particular taxpayer or group of taxpayers. This same reluctance is to be expected in connection with agreements or rulings on TP matters.

Little information is available on the process for competent authority claims. Experience suggests that the competent authority process has not been widely used in Kenya. The lack of experience and the limited number of double tax agreements (DTAs) means that competent authority claims or reliance on mutual agreement procedures (MAPs) to resolve disputes will be problematic.

Legislation and guidance

Section 18 (3) of the Kenyan Income Tax Act, Chapter 470 of the Laws of Kenya requires business carried on between a non-resident and a related-Kenyan resident to be conducted at arm's length and gives the Commissioner of Tax the power to adjust the profits of the Kenyan resident from that business to the profits that would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length. The Kenyan Income Tax (Transfer Pricing) Rules, 2006, Legal Notice No. 67 of 2006 (TP rules) published under section 18 (8) of the Kenyan Income Tax Act with an effective date of 1 July 2006, provides guidance on the determination of arm's-length prices.

Under section 18 (3) of the Kenyan Income Tax Act and the TP rules, persons or enterprises are related if either of them participates directly or indirectly in the management, control or capital of the other or if a third person participates directly or indirectly in the management, control or capital of both. Control is not specifically defined in this section, but is elsewhere defined in the Kenyan Income Tax Act to mean the holding of shares with voting power of 25% or more. In practice, this definition has been adopted for TP purposes. The definition of related parties has been expanded to include relationships with natural persons, and the section has been amended to ensure that it is not interpreted only in an anti-avoidance context. Prior to the amendment, there may have been an (untested) legal interpretation that the KRA could make TP adjustments only if it could prove a tax avoidance motive.

The TP rules state that they apply to transactions between branches and their head office or other related branches. Doubts as to the legitimacy of this provision have arisen in light of the restrictive application of section 18 (3) to 'resident persons', which excludes branches. Notwithstanding, the widely held view is that it is prudent

for branches to apply the TP rules in their dealings with their head offices and other branches for two reasons. Firstly, the intention that, at the local level and at the international level in the Organisation for Economic Co-operation and Development (OECD), the arm's-length principle should be extended to branches is clear. Secondly, the arm's-length principle is an implicit requirement in other sections of the Kenyan Income Tax Act, for instance with respect to the requirement for reasonableness of allocation of head-office costs incurred by branches.

Transactions subject to adjustment include: the sale or purchase of goods; sale, transfer, purchase, lease or use of tangible and intangible assets; provision of services; lending or borrowing of money; and any other transactions that affect the profit or loss of the enterprise involved.

The KRA has seven years from the year in which the income in question was earned in which to make an assessment. For years in which fraud, intentional negligence or gross negligence on the part of the taxpayer is suspected, there is no time limit in which the KRA must make an assessment in respect of TP.

Penalties

No special penalties apply in respect of additional tax arising from a TP adjustment. However, the general penalty applies – currently 20% of the principal tax and late payment interest of 2% per month.

Documentation

The TP rules do not make it an express statutory requirement for taxpayers to complete supporting TP documentation. However, Rule 9 (1) gives the Commissioner permission to request information including documents relating to the transactions where the TP issues arise and a non-comprehensive list of the documents that the Commissioner may request is provided in Rule 9 (2). Rule 10 similarly requires a taxpayer who asserts the application of arm's-length pricing to provide supporting documentation, evidencing the taxpayer's analysis upon request by the Commissioner. The KRA has interpreted these provisions to mean that a taxpayer is required to have documentation in place in readiness for any such request from the Commissioner.

The documents which the Commissioner may request are required to be prepared in, or to be translated into, English and include documents relating to:

- the selection of the TP method and the reasons for the selection
- the application of the method including the calculations made and price adjustment factors considered
- the global organisation structure of the enterprise
- the details of the transactions under consideration
- the assumptions, strategies and policies applied in selecting the method, and
- such other background information as may be necessary regarding the transaction.

In providing guidance on the nature of documentation required, Rule 9 (2) does not include any hard and fast rules for compiling documentation or the process that taxpayers should follow.

Kenya

Transfer pricing controversy and dispute resolution

Legal cases

The Unilever case is a key precedent in TP in Kenya In this case, the High Court of Kenya endorsed the use of OECD Guidelines in the absence of detailed guidance from the KRA. The Government's response to this judgment was the introduction of the TP rules, which are largely based on the OECD Guidelines. There have been no court cases since the introduction of the TP rules.

Burden of proof

In Kenya, the burden of proof is on the taxpayer to demonstrate that the controlled transactions have been conducted in accordance with the arm's-length standard.

Tax audit procedures

The KRA takes a rigorous approach to audits. The KRA regularly requests TP documentation from taxpayers with cross-border-related-party transactions with the intention of risk profiling them for the purpose of conducting TP audits. Previously, there was an attempt to audit all multinationals with related-party dealings, which meant that a lot of resources were being deployed to audits that were eventually abandoned midstream. There is now a movement to carry out upfront risk profiling before a full audit is launched.

Resources available to the tax authorities

A specialist TP unit has been established within the Large Taxpayers Office of the KRA and it is responsible for conducting TP audits on the larger multinationals. The Medium Taxpayers Office also carries out TP audits, although they do not have a specialist team. Investment has been made in developing specialist expertise within the KRA through training locally and abroad. Additionally, the KRA is a member of the African Tax Administration Forum (ATAF).

Risk transactions or industries

The KRA has stated that the agricultural industry and the oil and gas industries are at risk. Inbound management services are also routinely queried by the KRA.

Competent authority

Little information is available on the process for competent authority claims. Experience suggests that the competent authority process has not been widely used in Kenya. The lack of experience and the limited number of DTAs means that competent authority claims or reliance on MAPs to resolve disputes will be problematic.

Advance pricing agreements (APAs)

Kenya has no procedures in place by which a taxpayer might achieve an APA to its TP policy. In general terms, the KRA is reluctant to give binding rulings regarding practices or policies adopted by a particular taxpayer or group of taxpayers. This same reluctance is to be expected in connection with agreements or rulings on TP matters.

Anticipated developments in law and practice

The KRA intends to introduce Practice Notes to assist taxpayers in their review of their TP policies.

Liaison with other authorities

Although customs and income tax are under the same authoritative body, they are administered by distinct and separate departments within the KRA, and there is very little sharing of information between the two departments. There also appears to be lesser understanding by customs' officials on TP.

Joint investigations

The KRA is part of the ATAF, a body that is partly responsible for enhancing the technical expertise of African tax authorities. It is unclear the extent of cooperation by the KRA with tax authorities within the ATAF.

The Kenyan Income Tax Act allows the Minister for Finance to enter into Tax Information Exchange Agreements with other governments, which allows the KRA to exchange information with other tax jurisdictions and enhance the audit of multinational companies. This provides scope for exchange of information during a joint investigation by the KRA and revenue authorities in other tax jurisdictions.

Comparison with OECD Guidelines

The TP rules are based on the OECD Guidelines and are the basis for determining an acceptable TP methodology. Rule 7 of the TP rules stipulates which TP methods are available to persons. The methods listed include:

- the comparable uncontrolled price (CUP)method
- the resale price method (RPM)
- the cost plus CP) method
- the profit split method (PSM)
- the transactional net margin method (TNMM), and
- any other method prescribed by the Commissioner from time to time, where in their opinion and in view of the nature of the transactions, the arm's-length price cannot be determined using any of the above methods.

According to the rules, a person shall apply the *method most appropriate* for their enterprise, having regard to the nature of the transaction, or class of transaction, or class of related persons or function performed by such persons in relation to the transaction.

Use and availability of comparable information

Use

Within the context of the TP rules and the OECD Guidelines, any information gained on the performance of similar companies would be acceptable in defending a TP policy.

Availability

Information on the performance of listed public companies in Kenya is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available. Although the KRA has in the past confirmed that, under certain circumstances, it would accept the use of financial databases used elsewhere in the world, and specifically Amadeus/Orbis, the KRA has recently advocated for the use of local comparables or for applying geographic adjustments to overseas comparables. However, in practice, the use of the financial databases is accepted.

Kenya

58.

Korea, Republic of

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Overview

Since the introduction of the Korean transfer pricing (TP) regulations, TP has become one of the most important international tax issues concerning taxpayers engaged in cross-border inter-company transactions. The Korean TP regulations are based on the arm's-length standard and are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines. The Korean TP regulations prescribe TP methods, impose TP documentation requirements, and contain provisions for advance pricing agreements (APAs) and mutual agreement procedures (MAPs).

Numerous amendments have been made to the TP regulations over the years. Recent significant revisions, effective 1 January 2011, have included the codification of the most reasonable TP method, corresponding downward adjustments if transfer prices exceed arm's length, the use of multiple year data, the increase in penalty for failure to submit TP documentation, and detailed guidance on the preparation of TP documentation. These amendments provide taxpayers with increased flexibility in applying TP methods, but at the same time reflect continued efforts by the National Tax Services (NTS) to enforce TP compliance.

Country	**Korea, Republic of**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	When the tax return is filed or upon request
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes

Korea, Republic of

Country	Korea, Republic of
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of both the adjustment to taxable income and the adjusted tax due

Introduction

Prior to 1996, transfer prices charged on inter-company transactions involving Korean taxpayers were governed by Korea's Corporate Income Tax Law (CITL). In an effort to update and to conform the Korean TP regulations to internationally recognised rules and principles, the Law for the Coordination of International Tax Affairs (LCITA) was promulgated on 6 December 1995, and then supplemented by a Presidential Enforcement Decree (LCITA-PED) and an Enforcement Regulation (LCITA-ER), which were announced on 30 December 1995, and 30 March 1996, respectively. In addition, several basic tax rulings under the LCITA (LCITA-BTR) were issued on 15 June 2004, which provide further guidance in interpreting the LCITA.

Since the introduction of the LCITA, TP has become the single most important international tax issue facing multinational companies doing business in Korea. The NTS has stated that the enforcement of TP compliance is one of their highest priorities, and has made efforts to provide training to their tax audit workforce with respect to TP.

Korea introduced provisions for APAs in 1997, and competent authority/MAPs available for tax treaty countries.

Legislation and guidance

The Korean TP regulations are based on the arm's-length standard and generally consistent with the OECD Guidelines.

The TP methods specified in the LCITA and LCITA-PED are listed below:

- Comparable uncontrolled price (CUP) method, resale price method (RPM) or cost plus (CP) method.
- Profit split method (PSM) and transactional net margin method (TNMM).
- Other unspecified methods.

Prior to 1 January 2011, the LCITA stipulated that the selection of the appropriate TP method should be based on the above hierarchy. As a result of recent amendments to the LCITA, however, transfer prices should now be supported by the most reasonable TP method without consideration to the order of method priority.

In addition to TP, the LCITA also covers:

- interest paid to a controlling overseas shareholder
- corporate income retained in tax havens
- offshore gifts, and
- international cooperation among tax administrations.

Intragroup services

In Korea, management services have been subject to intense scrutiny from the NTS. The importance of TP for intragroup services (including management service fees) is evidenced by amendments to Korean TP regulations in 2006, whereby taxpayers are required to report certain information (nature of the services received/provided, the main business of service provider, TP method, reason for selecting the method, type of service [direct or intragroup service], type of charge [direct charge or allocation], and allocation basis), if applicable, as part of their corporate tax return.

Article 6-2, paragraph 1 of LCITA-PED provides that fees paid in connection with service transactions between a resident and its foreign affiliate, such as the performance of management, financial advisory, payment guarantee, information technology, technical support or other business-related activities, will be considered arm's length and treated as deductible expenses for tax purposes if all of the following requirements are met:

1. The service provider provides services according to the terms of the service agreement, which is made prior to providing the services.
2. The service recipient has expected benefits from the services received in the form of additional revenue or reduced costs.
3. Service fees paid for such services are computed according to the TP method(s) set forth in the LCITA. Where the service fees are determined using the CP method or the TNMM, the arm's-length price shall be determined considering the following:
   - The cost base shall include all costs, either directly or indirectly, incurred in connection with the provision of the services.
   - Where the service provider partially or fully outsources the services to a foreign affiliate or a third party, initially makes payment to the foreign affiliate or the third party for their services and subsequently bills the service recipient for reimbursement, a mark-up should be applied only to the costs incurred in connection with the services directly performed by the service provider. However, exceptions may apply if the nature of the services, circumstances surrounding the transaction, and common practices prove that the mark-up on the outsourced services are reasonable.
   - Supporting documents exist which substantiate the facts from paragraph 1 through 3 above.

Notwithstanding paragraph 1 above, the provision provides that where the services received by the service recipient are identical to those performed by another foreign affiliate on its behalf or to those provided by a third party to another foreign affiliate, such services do not fall under the scope of intragroup services as stipulated in paragraph 1. However, temporary duplicative services may be considered as intragroup services within the scope of paragraph 1, where valid business reasons exist (e.g. business and group reorganisation, restructuring, reduced failures in business decision-making).

According to LCITA-BTR 4-0-2, intragroup service fees paid by a Korean resident to an overseas' parent company or foreign affiliate will only be deductible for tax purposes if the actual provision of services can be verified through proper documentation including a schedule of service performance, description of services provided, information on the company providing the services and its employees, detailed expense reports, etc.

LCITA-BTR 4-0-2 also states that shareholder (stewardship) activities such as activities relating to the parent company's reporting responsibility (e.g. preparation of financial statements, consolidation of reports, etc.) and various supervising or controlling activities (e.g. internal audit) are not considered to be intra-group services and are, as a result, not deductible for tax purposes.

Other regulations

The LCITA supersedes all previous domestic corporate tax laws and TP guidelines published by the NTS.

On 15 June 2004, the NTS issued basic tax rulings under the LCITA, which are intended to provide guidelines for interpretation of the LCITA in accordance with internationally accepted rules and standards for taxation. These basic tax rulings consist of 29 sections and are the first rulings applicable under the LCITA since its enactment. The highlights of the basic tax rulings include sections on the deductibility of management service fees, factors when selecting comparable transactions, application of the CUP method or the RPM, circumstances for applying the Berry ratio and the use of the interquartile range.

In addition, the NTS issues official rulings upon request by taxpayers. Although these rulings are interpretations of the law for specific cases and are not legally binding, they are usually applied to similar cases. The rulings provide practical guidelines and are very influential.

Penalties

General

Taxpayers are liable to pay additional corporate tax on the TP adjustment amount at relevant tax rates. In addition, an underreporting penalty of 10% and an underpayment penalty (interest) of 10.95% per annum will apply on the additional tax liability. A local tax of generally 10% is further levied on the additional tax amount and penalties combined. However, the LCITA stipulates that under-reporting penalty does not apply in situations where a taxpayer has obtained an APA.

Penalty for failure to submit requested documentation

The LCITA imposes a penalty for failing to comply with information requests issued by the NTS. If a taxpayer fails to submit requested TP information, the NTS may refuse to accept such information if it is submitted at a later date (e.g. when filing a tax appeal or in the course of MAPs).

In addition, if a taxpayer is requested to submit TP information but fails to do so within the due date without a justifiable reason or submits false information, the taxpayer may be fined up to 100 million Korean won (KRW).

Effective on tax years starting on or after 1 January 2015, a fine of KRW 100 million will be levied for failure to submit the summary of inter-company transactions with overseas related parties, which should be filed as part of the annual corporate income tax return. The summary of inter-company transactions should be accompanied by income statements of the transacting overseas related parties, hence this fine could also apply for failure to disclose such financial information.

Documentation

Primary documentation

The regulations also contain primary and secondary TP documentation requirements. Primary documentation requirements refer to TP documentation that taxpayers are required to submit each year as part of their corporate income tax return. Primary documentation forms include:

- Declaration of TP method.
- Summary of international transactions.
- Summary of income statements of overseas affiliates.

The declaration of the TP method form requires a taxpayer to report the TP method or methods used to establish or determine their transfer prices. In addition, a taxpayer is required to provide an explanation for the particular method adopted. The TP method should be the most reliable method among those available and should justify the arm's-length nature of the taxpayer's transfer prices. Separate declaration forms are required for transactions involving transfers of intangible property, services, and cost-sharing arrangements.

The summary of international transactions' forms provides the NTS with a summary of the taxpayer's inter-company transactions, according to transaction counterparty and type of transaction. Taxpayers are required to report the following: (i) the name of each overseas' related party with whom the taxpayer engages in transactions; (ii) the relationship between the taxpayer and the overseas' related party; (iii) the nature of the transaction (e.g. tangible goods, service, financing and investment); and (iv) the amount of the transaction.

The summary of income statements of overseas affiliates requires a taxpayer to submit the income statement of each overseas affiliate with whom it engages in transactions. The overseas' affiliate income statements should be submitted for the most recent tax year and should be prepared to the profit-before-tax level. In addition, the taxpayer should indicate the primary business activities of the overseas' related parties and the taxpayer.

Although there is no concept of immateriality (or a *de minimis* transaction) in the Korean regulations, a taxpayer is not required to submit the Declaration of Transfer Pricing Method form at the time of filing the corporate income tax return if the taxpayer is engaged in cross-border inter-company goods' (or service) transactions that accumulatively amount to below KRW 5 billion (KRW 1 billion for service transactions) or amount to below KRW 1 billion (KRW 200 million for service transactions) per transaction party.

Likewise, the taxpayer is not required to submit a Summary of Income Statements of Overseas Affiliates if it is engaged in cross-border inter-company goods' (or service) transactions that amount to below KRW 1 billion (KRW 200 million for service transactions) per transaction party or if the taxpayer has submitted a list of overseas affiliates and their summarised financial statements in accordance with the CITL.

Secondary documentation

Taxpayers are also required to provide the NTS, upon request, with other documentation that supports the arm's-length nature of their transfer prices.

Secondary documentation includes inter-company agreements; corporate TP policies; organisational charts; financial statements segmented by business, product line or function; business descriptions; the selection and application of the TP method; and any other documents that may be useful to evaluate the arm's-length nature of a taxpayer's transfer prices.

Substantially all of the information requested as part of secondary documentation is consistent with the contents generally contained in a standard TP documentation study.

Requests for TP documentation are made during tax audits and formal requests for TP documentation from the NTS. Taxpayers are required to submit TP documentation to the NTS within 60 days of the request; however, a one-time 60-day extension may be allowed upon application. During a tax audit, however, secondary documentation as well as other supporting documentation must be provided promptly, because the duration of tax audits is often very short and the auditors want to resolve all issues within the short timeframe.

Contemporaneous documentation

On 26 December 2008, Korea introduced provisions to provide penalty relief to taxpayers maintaining contemporaneous documentation. The penalty waiver provision stipulates that the under-reporting penalty (i.e. 10% of the additional corporate income tax) may be waived in the event of a TP adjustment if a taxpayer has maintained contemporaneous TP documentation (i.e. at the time of filing of the corporate income tax return) and the TP method has been reasonably selected and applied.

A taxpayer who wishes to obtain penalty relief should maintain the following documentation and submit the documentation within 30 days when requested by the NTS:

- General descriptions of the business (including analysis of the factors that may affect the prices of assets and services).
- Information that may affect transfer prices including information on foreign-related parties and their relationships with the taxpayer (group organisation structure.
- The following documentation, which supports the selection of the TP method stated on the taxpayer's corporate income tax return:
    - Economic analysis and forecast data supporting the selection of the most reasonable TP method stated at the time of filing the corporate income tax return.
    - Profitability of the selected comparable companies and the descriptions of adjustments applied during the analysis of the arm's-length price.
    - Descriptions of other potentially applicable TP methods and the reasons why these TP methods could not be selected.
    - Additional data prepared to determine arm's-length prices after the end of the tax year and within the filing period of the corporate income tax return.

In addition, the assessment of whether a taxpayer has reasonably determined the arm's-length price is determined by considering the following factors:

- Data on profitability of comparable companies obtained at the end of the tax year should be representative and not wilfully exclude the profitability of a certain comparable company to derive an arm's-length price favourable to the taxpayer.
- Collected data should be systemically analysed to select and apply the TP method.
- If the taxpayer has selected and applied a TP method different from the one applied in an APA concluded during the previous tax year or a TP method selected by the tax authorities during a previous tax audit, there should be a valid reason as to why the different TP method was applied.

Transfer pricing controversy and dispute resolution

Tax audit procedures

Selection of companies for audit
In general, the NTS examines corporate income tax returns including TP-related documentation, to identify taxpayers who display signs of non-compliance with TP regulations. The NTS then requests additional information from suspected taxpayers for review. Taxpayers who fail to submit TP-related data required by the LCITA are more likely to be selected for an audit. Taxpayers are also generally subject to periodic audits every four to five years, based on the five-year statute of limitations for taxes.

The NTS can request any relevant information deemed necessary for an audit (e.g. contracts, price lists, cost data of manufactured goods, accounting principles used, organisation charts and mutual investment agreements). Since it is likely that the attitude of the taxpayer will affect both the outcome of the audit and/or the size of any adjustment, it is imperative that the taxpayer be cooperative during the negotiation process. Therefore, taxpayers are obliged to provide the requested information to avoid adverse consequences.

Secondary adjustments
A unique and problematic aspect of the Korean TP regulations is the view on secondary adjustments. Secondary adjustments are additional tax assessments that are performed if a TP adjustment is not repatriated back to Korea. Most secondary adjustments are treated as deemed dividends, subject to withholding taxes at the rate specified in the corporate tax law or applicable treaty.

Transfer pricing review committee
On 30 June 2005, the NTS announced the establishment of a Transfer Pricing Review Committee (TPRC) to review proposed TP adjustments prior to the finalisation of a tax audit. Under the auspices of the Assistant Commissioner for International Taxation, the TPRC is designed to ensure that taxpayers are treated fairly and consistently with respect to TP assessments. The TPRC is responsible for reviewing proposed adjustments that are in excess of KRW 5 billion or that are disputed by a taxpayer. The TPRC may also review proposed TP adjustments stemming from other issues on a case-by-case basis.

Domestic tax appeal procedure and mutual agreement procedures
A variety of domestic appeal options are available to taxpayers including the following:

- Pre-Assessment Protest (filed at the district, regional or head tax office of the NTS).
- Request for Investigation by the NTS.
- Request for Adjudication by the Tax Tribunal (TT).
- Appeal to the Board of Audit and Inspection (BAI).

Most domestic tax appeals are filed with the TT. Moreover, taxpayers may only pursue court litigation after appealing to the NTS, TT or BAI. For several reasons, most TP disputes move to MAPs. First, taxpayers who initiate MAPs may apply for a suspension on the payment of a tax assessment depending on how quickly MAPs can be initiated. This option is not available to taxpayers pursuing domestic tax appeals, except in very limited circumstances. Second, pursuing MAPs increases the likelihood of obtaining relief from double taxation and a waiver on under-reporting penalties. Finally, MAPs encourage tax authorities to rely on generally accepted TP rules and standards during negotiations.

Burden of proof
Korean tax laws do not clearly specify where the burden of proof lies with regard to supporting or challenging transfer prices. However, a taxpayer is required to report and justify the TP method(s) used to establish or evaluate its transfer prices each year, at the time of filing its corporate income tax return. If the taxpayer has submitted proper documentation, the NTS must demonstrate why the taxpayer's transfer prices are not at arm's length and propose a TP adjustment to challenge the taxpayer's transfer prices. Once the NTS has proposed an alternative TP method and adjustment, the taxpayer must defend the arm's-length nature of its transfer prices.

In the event that a taxpayer does not provide the NTS with proper TP documentation at the time of filing its corporate income tax return, the burden of proof falls on the taxpayer to corroborate the arm's-length nature of its transfer prices.

Legal cases
A handful of legal cases involving TP have been filed, but very little information on these cases is publicly available. Some cases have been settled out of court, some cases are currently pending in domestic appeals and other cases have been elevated to MAPs.

Use and availability of comparable information
Taxpayers may use various forms of comparable information to support their TP policies including internal and third-party data. Several company directories and electronic databases are available in Korea which contains detailed information and data on Korean companies.

Risk prone transactions or industries
The LCITA states that any transaction with overseas' affiliates may be subject to TP adjustments. Recently, the NTS has aggressively challenged royalty payments and management service fees. The NTS also scrutinises transactions with affiliates located in countries that are considered tax havens and conducts industry-wide tax audits in certain industries (e.g. pharmaceutical, tobacco, luxury goods, etc.). Other peculiar situations may also draw the NTS's attention, such as when a distributor incurs operating losses or when a company adopts different TP policies that reduce the amount of taxes paid.

Limitation of double taxation and MAPs

The LCITA contains detailed information on MAPs, which taxpayers may use to seek relief from double taxation.

Advance pricing agreements (APAs)

The Korean APA programme was launched on 1 January 1997. Taxpayers may apply for unilateral or bilateral APAs. An APA can cover any number of years, but most applications are for a five-year period. Rollback is available for up to three years under a unilateral APA and five years under a bilateral APA. A taxpayer must apply for an APA by the end of the first taxable year for which the APA is being sought.

To apply for an APA, a taxpayer must complete and submit a formal application that describes the transactions for which the APA is being requested, the overseas affiliates involved, the TP method to be applied and the period requested to be subject to the APA. In addition, the taxpayer must provide a description of its business activities and organisation structure as well as the financial statements and tax returns for the transacting parties for the most recent three years. The taxpayer may avoid having to submit some information if it can clearly demonstrate that the information is irrelevant.

After the terms of the APA have been finalised, the results are legally binding on the NTS, but not the taxpayer. In other words, if the taxpayer's transfer prices are determined to be within the range previously agreed to with the NTS, the NTS cannot make an adjustment. The taxpayer, however, is not required or bound to meet the conditions of the APA should they choose not to adhere to the terms reached under the APA.

The taxpayer has the right to withdraw or modify the request for an APA at any time prior to obtaining the NTS' final approval. In the event that a taxpayer decides to withdraw the application for an APA, all submitted data is returned to the taxpayer without further consequence.

APA requests are completely confidential and the data submitted to the NTS may only be used for reviewing APA requests and follow-up purposes.

As in other countries, APAs allow Korean taxpayers to obtain certainty on the acceptability of transfer prices, eliminating the risk of penalties and double taxation. Additional benefits of applying for APAs include the possibility of obtaining the assistance of foreign tax authorities to help persuade the NTS of the reasonableness of the request and the opportunity to negotiate with high-level NTS staff rather than regional tax-office personnel (as in the case of audits). The number of APA requests is anticipated to increase significantly over the next several years as they are actively promoted by the NTS.

Cooperation with customs' authorities

Effective 1 July 2012, the NTS and the Korea Customs Service (KCS) introduced dual and symmetrical provisions to the LCITA and Korean customs' law to provide correlative adjustments on TP adjustments and/or customs' duties' assessments. The new mechanism provides taxpayers with an opportunity to request correlative adjustments in the two following scenarios:

If a taxpayer receives a TP income adjustment on import transactions, the taxpayer may request a refund of overpaid customs duties based on the adjusted price.

- If a taxpayer receives an imposition of customs' duties in relation to import price, the taxpayer may request a refund of corporate income tax based on the adjusted import price, and the taxpayer may request a refund of corporate income tax based on the adjusted import price.
- The correlative relief mechanism is only available in limited situations. It may not apply to voluntary adjustments to transfer prices or import prices or for taxpayers with APAs or Advance Customs Valuation Arrangements (ACVAs).

The correlative adjustment procedures have led to the establishment of a Pricing Review Committee, which is responsible for reviewing situations where the NTS and/or the KCS denies a taxpayer's request for correlative adjustments. The Pricing Review Committee is only empowered to make recommendations as a mediator: the NTS, KCS and the taxpayer are not obligated to follow the Committee's recommendations. Additional provisions were also introduced regarding the exchange of information between the NTS and the KCS to help facilitate fairness and transparency.

Unfortunately, given that there have been no fundamental changes to the LCITA or customs law with respect to the convergence in standards for measuring TP and customs' compliance and the fact that the recommendations of the Pricing Review Committee are not binding on the NTS and KCS, this post-assessment correlative adjustment mechanism has not been effectively executed in practice.

Accordingly, in another attempt to harmonise TP and customs value, Korea introduced a new mechanism for advance correlative adjustment on the determination method of the customs value and transfer price. Unlike the mechanism that was introduced in 2012, this new mechanism provides taxpayers with an opportunity to request an advance correlative adjustment, which would essentially be a mutual agreement on the customs value and transfer prices by the KCS and the NTS.

To be eligible for the advance correlative adjustment, the methods employed for customs valuation purposes and TP purposes must be similar. In other words, it will be only available when one of the three traditional transactional methods for TP and the four customs valuation methods are adopted to determine the customs value and transfer price.

Comparison with OECD Guidelines

Korea is the 29th member of the OECD. The Korean TP regulations are largely based on the OECD Guidelines.

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Kuwait

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Overview

Kuwait does not currently have specific transfer pricing (TP) guidelines. However, guidance on related-party transactions is provided under the Head-office expenses/payments to foreign affiliates part of the Deductions section, which places a unique formulaic approach, governing payments relating to import of materials and equipment, design expenses incurred abroad and head-office expenses. Additionally, Kuwait does not impose income tax on companies wholly owned by nationals of Kuwait and other Gulf Cooperation Council countries (GCC) countries. However, GCC countries with foreign ownership are subject to taxation to the extent of foreign ownership.

Country	**Kuwait**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Documentation is not mandatory
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	N/A

Kuwait

Introduction

The Ministry of Commerce in Kuwait has issued the new Companies Law No. 25 of 2012 (Company Law), which replaced the Commercial Companies Law No. 15 of 1960. The new law has been drafted to encourage investments in Kuwait and introduces a raft of new concepts and principles, set to shape the way commercial entities operate in Kuwait.

Kuwait has double tax treaties in force with various countries including Austria, Belarus, Belgium, Bulgaria, Canada, People's Republic of China, Croatia, Cyprus, Czech Republic, Ethiopia, France, Germany, Hungary, India, Indonesia, Italy, Jordan, Korea, Lebanon, Malta, Mauritius, Mongolia, Netherlands, Pakistan, Poland, Romania, Russian Federation, Singapore, South Africa, Sri Lanka, Sudan, Switzerland, Syria, Tunisia, Turkey, Ukraine, and the United Kingdom.

In addition to the previously mentioned treaties, Kuwait has signed the following tax treaties, but they have not been ratified yet: Bangladesh, Cyprus, Djibouti, Egypt, Goaiania, Indonesia, Ireland, Japan, Kenya, Lebanon, Myanmanr, Nigeria, North Korea, Romania, Slovakia, Syria and Zambia.

Legislation and guidance

Kuwait does not currently have specific TP guidelines. However, guidance on related-party transactions is provided under the Head-office expenses/payments to foreign affiliates, part of the Deductions section. Accordingly, it states that the deduction of head-office expenses (the overhead or indirect expenses) is limited to 1.5% of the company's Kuwaiti revenue after deducting the subcontractors' shares (if any).

The direct costs allocated by the head office (e.g. supply of goods, design and consultancy costs) are regulated as follows:

With regard to goods costs incurred outside Kuwait, head offices are allowed to receive 85% to 90% of the revenues, while affiliated companies can receive 90% to 93.5% of the revenues, whereas third parties can receive 93.5% to 96.5% of the revenues in return for the provision of goods.

For design costs incurred outside Kuwait, head offices are allowed to receive 75% to 80% of the revenues, while affiliated companies can receive 80% to 85% of the revenues, whereas third parties can receive 85% to 90% of the revenues in return for the provision designs.

For consultancy costs incurred outside Kuwait, head offices are allowed to receive 70% to 75% of the revenues, while affiliated companies can receive 75% to 80% of the revenues, whereas third parties can receive 80% to 85% of the revenues in return for the provision consultancy services.

In case there is no separate revenue for consultancy, design or goods work, although the nature of the contract requires the existence of consultancy work, the following formula shall be applied:

Consultancy, design or goods revenue = (consultancy, design, or goods costs/total direct costs) * contract revenues.

Penalties

The taxpayer must submit a tax return, based on the taxpayer's books of account, within three months and 15 days of the end of the taxable period. A foreign entity can request an extension of up to 30 days for filing the tax declaration. The maximum extension in time to be granted will be 60 days. If such an extension is granted, no tax payment is necessary until the tax declaration is filed, and payment must then be in one lump sum.

The taxpayer must keep in Kuwait certain accounting records, which are subject to inspection by the tax department's officials. Accounting records may be in English and may be in a computerised system used to prepare financial statements, provided that the system includes the required records and the tax department is previously informed.

As a general rule, an assessment is finalised only after inspection of records by the tax department. As indicated above, proper documentation must be kept to support expenditure and to avoid disallowance at the time of tax inspection. If support is considered inadequate, the assessment is apt to be made on the basis of deemed profitability. This is computed as a percentage of turnover and is fixed arbitrarily, depending on the nature of the taxpayer's business.

Documentation

The Kuwaiti Tax Authority now requires more tax disclosure, analysis and information to be submitted along with the tax declarations. However, Kuwaiti Companies Law does not contain a specific TP documentation requirement.

Transfer pricing controversy and dispute resolution

Given the absence of TP guidelines with specific TP provisions (including delineation of specified TP methods), there are no specific rules regarding burden of proof.

Comparison with OECD Guidelines

Although Kuwait is not an Organisation for Economic Co-operation and Development (OECD) member, it acknowledges the importance of the OECD Guidelines as international best practice.

Kuwait

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Latvia

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Overview

Latvian transfer pricing (TP) rules are generally in line with the Organisation for Economic Co-operation and Development (OECD) practice while general rules have been present since 1995, while specific TP requirements have been in place since 2013. The attention of the tax authorities is expected to increase in the upcoming years.

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Country	**Latvia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border intercompany transactions?	Yes
Does TP legislation apply to domestic intercompany transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	When submitting the tax return. However, the TP documentation should only be presented upon a request of the State Revenue Service (SRS)
Must TP documentation be prepared in the official/local language?	Yes
Are related party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes

Latvia

Country	Latvia
How are penalties calculated?	As a percentage of both the adjustment to taxable income and the adjusted tax due

Introduction

The adoption of the Latvian Corporate Income Tax (CIT) Act in 1995 established a requirement that transactions with related parties should comply with the arm's-length principle. Since then, the development of TP regulation has been relatively slow. However, recently the Latvian State Revenue Service (SRS) started to tackle the TP issues actively and a set of supporting regulations, i.e. mandatory TP documentation regulations, and possibility to conclude advance pricing agreements with the SRS have been developed as of 2013.

Legislation and guidance

Statutory rules

The TP area in Latvia is governed by the following legislation:

Transfer pricing regulation	Description
The Taxes and Duties ('TD') Act Section 1	Definition of related parties
TD Act Section 15.2	The taxpayer's duty to provide information about transactions with related parties (i.e. TP documentation requirements)
TD Act Section 16.1	Procedures for the taxpayer and tax administration concluding advance pricing agreements
TD Act Section 23.2	Principles for the specification of goods, work and services' prices for the needs of the assessment of taxes
TD Act Section 32	Clarification of the amount of tax payment in case of a tax audit
CIT Act Section 1	Definition of related parties
CIT Act Section 12	Special provisions regarding affiliated undertakings (i.e. the arm's-length principle applicable to transactions between related parties)
The Commercial Code 182	Rules on funds paid to shareholders
The Cabinet of Ministers' 3 January 2013 Rule 16 ('CIT rule 16')	The procedure for entering into advance pricing agreement between the taxpayer and the tax administration
The Cabinet of Ministers' 4 July 2006 Rule 556 ('CIT rule 556')	Application of Corporate Income Tax Act
The Cabinet of Ministers' 20 December 2011 Rule 981 ('CIT rule 981')	Rules on the corporate income tax return for the tax period and the calculation of advance payments

Transactions

Latvian law requires taxpayers to provide evidence that the transaction price matches the market price (i.e. is at arm's length). The requirement is applicable to Latvian resident taxpayers and permanent establishments that engage in transactions with:

- a related party treated as a related foreign entity (i.e. exceeding 20% of direct or indirect shareholding)
- local companies that form a 90% group with the taxpayer
- companies, partnerships or cooperatives that are exempt from CIT or enjoy CIT relief
- individuals considered related to the company (e.g. individuals with a shareholding of more than 50%, board members, etc.)
- a company located in a low-tax jurisdiction.

Taxable income specifically for CIT purposes must be adjusted if the price applied to any of the following related-party transactions differs from its arm's-length value:

- Fixed assets, goods or services sold at below-market prices.
- Fixed assets, goods or services bought at above-market prices.
- Other transactions entered into by Latvian taxpayers.

The TD Act states in determining the market price or value of a transaction that any discounts and mark-ups applied to transactions between unrelated parties should be taken into account, as well as any pricing changes driven by the following factors:

- Demand fluctuations due to seasonality or other factors.
- Differences in the quality or characteristics of goods or services.
- Expiry of the sell-by date.
- Marketing policy on placing new products in the market or placing products in a new market.
- Sales of samples and demo versions to attract customers.

The TD Act also provides for a wider application of the arm's-length principle than only between related parties. A tax audit may examine and adjust the price of the following transactions:

- Transactions between related parties.
- Barters and set-offs.
- Price deviations exceeding 20% of prices that a taxpayer had applied to similar goods or services over a short period.
- Exports and imports.

Calculating an arm's-length price

The CIT rule 556 prescribes five TP calculation methods that are consistent with the OECD Guidelines:

- Traditional transaction-based TP methods:
  - The comparable uncontrolled price method.
  - The resale price method.
  - The cost-plus method.
- Transactional net profit methods:
  - The transactional net margin method.
  - The profit split method.

The CIT rule 556 gives a preference to the three traditional transaction-based methods, whereas the transactional profit methods are to be used only when all of the traditional transaction-based methods are inadequate or inapplicable.

Reporting related-party transactions

Latvian taxpayers are required to report transactions with related parties on a special form as an attachment to their annual CIT return according to the CIT rule 981. The addendum gives the identification or details of the related company, describes the nature of the transaction, states the amount of business conducted and specifies the method applied for the particular transaction.

Use and availability of comparable information

The SRS has acquired the Van Dijk Bureau database Analyse Major Databases from European Sources (i.e. AMADEUS) to be able to perform independent benchmarking.

The TP legislation also provides that if the price of a transaction is not at arm's length, then the tax authorities may determine during a tax audit the market price of the transaction, relying on the following methods and information sources:

- Internal comparables of the taxpayer.
- Prices and values that independent companies have applied in similar transactions.
- Calculating the costs of the transaction and adding a mark-up calculated in line with the industry average financial results derived from either the Latvian Central Statistical Office database or the tax authorities' own databases, but if such information is not available, the relevant average profitability indicators from the information base established by the SRS.
- Using the average price of similar goods as provided by the Central Statistical Office.
- Engaging an independent valuation expert.

Limitation of double taxation and competent authority proceedings

Almost all double taxation agreements (DTAs) contain a clause relating to competent authority proceedings (i.e. mutual agreement procedures). However, there is no information about the SRS involvement with competent authority proceedings because no such information is published.

The CIT Act explicitly allows the TP corresponding adjustment. If the person or company related to the Latvian company has made a TP adjustment, the Latvian company may reduce its taxable income by the same amount. However, the corresponding adjustment is restricted to transactions with a company resident in Latvia, another EU member country or an EEA country that has an effective DTA with Latvia.

Advance pricing agreements

The TD Act provides the procedure for advance pricing agreements for enterprises that already have or plan to have intercompany transactions in excess of 1.43 million euros (EUR) per year. As such, the legislation allows taxpayers to confirm with the competent authorities transactions entered into past periods.

The CIT rule 16 on advance pricing agreements (APAs) became effective on 1 January 2013. The CIT rule 16 on APAs states that a taxpayer seeking an APA should prepare and file with the SRS documentation containing the following information, although additional information may be requested:

Documents	Description
Application	• Name of the taxpayer, its registration number and legal address • Related foreign enterprise involved in the transaction • The type of transaction that will be covered by the APA • Transfer pricing method for determining the market value of the transaction • Period covered by the APA • Legal justification for the chosen TP method, as well as for the submission of the application
Industry analysis	• Information on the industry within which the taxpayer conducts its operations (e.g. development trends, characteristics) • Economic and legal factors affecting the prices of the taxpayer's goods or services • A description of the business environment (competition, scope for sales and other market factors) • The role of intangible property • Main transaction flows among the members of the group's organisational structure that could affect the related-party transaction • Functions, risks and assets undertaken by the companies in a particular industry
Company analysis	• Taxpayer's key areas of commercial or entrepreneurial activities • Venues the taxpayer uses for performing these activities • Organisational and legal structure of the taxpayer and its global related entities demonstrating the ties among these entities • Information on the foreign-related entity involved in the transaction relevant to the APA • Financial and tax-related data including: • CIT returns, financial and annual reports for the last three years of the foreign-related entity involved in the transaction • Existing agreements among the related enterprises and persons pertaining to price determination and cost allocation • Description of the organisation of the bookkeeping • Marketing or finance reports, budgetary projects, commercial or entrepreneurial plans and overviews on the global product assortment and commercial segments • Corporate strategy including marketing and management strategy that can affect transfer prices • A description on the related-party transactions (contractual terms and goods or services) • Flow of goods, services, products and financial flows, as well as the currency used • Economic circumstances affecting the price of the transaction and the specifics of the applied commercial strategy • Proportion of remuneration from investments of intangible property attributable to each participant, its calculation method and substantiation if the expenses incurred in carrying out the transaction involve the use of intangible property
Functional analysis	• Functional analysis of every participant (includes a description of each participant's function, assumed risks and assets undertaken)
Economic analysis	• A description of how the TP method was selected • A benchmarking study

Documents	Description
Other information	• A list of agreements that the foreign-related entity has concluded with tax administrations if these are concluded in relation to this transaction or other similar transactions • If the foreign-related enterprise is undergoing a tax audit or is in the process of appealing a judgment in a case related to associated-party transactions, the description of any such events • Documentary evidence that the taxpayer has paid the APA application fee

The CIT rule 16 on APA states that, once the application is submitted, the SRS has to provide its official response on whether the APAs procedure is launched within a one-month period. If the SRS agrees with the request, it will provide its ruling within this period, although additional information may be requested.

The CIT rule 16 on APAs states that, if approved, the APA is valid for a period of three years, provided that no changes have occurred in the nature, substance or methodology of the transactions covered by the APA.

The fee for filing an advance pricing agreement application is EUR 7,114 with the following revised terms of payment:

- Twenty percent is payable before filing an application.
- Eighty percent is due after receiving confirmation from the SRS that an APA procedure has been launched.

It should be noted that if the SRS refuses to initiate the APA procedure with the taxpayer, it reserves the right not to refund the 20% of the fee.

Penalties

Current tax penalties prescribe the following penalty levels:

- If the tax charge for the period under review has been understated by one of the following:
  - Up to 15% of the tax charge, there is a possible penalty of 20% of the total tax liability that should have been reported.
  - More than 15% of the tax charge, there is a possible penalty of 30% of the total tax liability that should have been reported.
- If the taxpayer admits the understatement of tax, is willing to collaborate with tax authorities and to pay the understated amount, the imposed penalty will be reduced by 50%.

If a taxpayer who has already committed a repeat offence commits one or more similar offences within three years, there is a penalty of double of the amount (i.e. 40% or 60%) of the tax that should have been reported for each of these subsequent offences.

To make taxpayers less willing to undertake last-minute corrections to their tax returns right before a tax audit, the law imposes a penalty of 5% of any understated tax liability on a taxpayer that submits an adjustment and pays the outstanding tax and interest only after receiving a notice of the start of a tax audit. The penalty must be paid to the tax authorities before the date the tax audit starts.

The SRS director general may decide to reduce the penalty if the taxpayer admits an offence and pays the unreported tax and penalty of 50% of the total tax liability that should have been reported within 30 days of receiving the SRS decision on the tax audit results.

Documentation

As from 1 January 2013, the TD Act lays down requirements for TP documentation that Latvian CIT taxpayers must prepare to prove that their related-party transactions are at arm's length.

Taxpayers with a turnover in excess of EUR 1.43 million, having transactions with related parties which amount to at least EUR 14,300, must prepare documentation containing the following information:

Documents	Description
Industry analysis	• Development trends and key features of the industry • Economic and legal factors affecting the prices of the taxpayer's goods or services • A description of the business environment (competition, scope for sales and other market factors) • The role of intangible property, and • Functions, risks and assets undertaken by the companies in a particular industry
Company analysis	• The organisational and legal structure of the company and its related parties (group) • Corporate strategy including marketing and management strategy that can affect transfer prices • Details of the company's reorganisation that results in functions, risks or assets being transferred or acquired • A description of related-party transactions, contractual terms and goods or services, and • The company's business forecast according to its related-party transactions
Functional analysis	• Functional analysis giving information on the related parties' functions, risks and assets
Economic analysis	• A description of how the TP method was selected • A benchmarking study

The taxpayer has to provide full TP documentation in Latvian within 30 days after requested by the tax authorities.

The documentation requirement in general corresponds to the international practice related to TP study requirements, as reflected in the OECD Guidelines.

While the full TP documentation requirements apply to entities with sales exceeding EUR 1.43 million, other entities are still required to prove that their transfer prices are at arm's length. Normally, the SRS expects taxpayers to be able to show what TP method is used and how it has been applied, i.e. a benchmarking study of third-party comparables showing that the prices applied by the taxpayer falls within the arm's-length range.

Transfer pricing controversy and dispute resolution

Burden of proof

The TD Act places the burden of proof in tax matters including TP, firmly on the taxpayer. A tax decision issued by the SRS has to state only the basis for adjusting tax payment and calculating penalties. The taxpayer then has to provide proof to challenge the decision.

Tax audit procedures

Prior to 2013, in Latvia, TP was audited as part of a regular tax audit, which generally may cover up to three previous tax years. Starting with 2013 the statutory requirements for TP audits will cover up to a five year period.

The SRS must give a taxpayer at least ten days' written notice of a decision to conduct a tax audit. The notice must state the commencement date and duration of a tax audit, as well as taxes and duties and tax periods subject to the tax audit.

A tax audit may not take longer than 90 days, unless the SRS director general sanctions an extension. The duration of a tax audit may be extended by 30 days if additional information is required and by 60 days if such additional information has to be requested from foreign tax authorities or foreign companies. Any period between the date an information request is made and the date it is received will be excluded from the extension.

These temporal limitations do not apply to simultaneous tax audits in which the SRS liaises with the tax authorities of a foreign country in which the related party of a Latvian entity is registered as a taxpayer. Although simultaneous cross-border tax audits are not regular, the SRS during tax audits does use its right under effective double tax treaties to request information from corresponding countries' tax authorities.

Upon completion of a tax audit, the SRS must provide the taxpayer with an audit report that sets out the results of the audit. If any tax offence is identified, the SRS will prepare a decision about increasing the tax liability to include additional taxes and penalties.

Resources available to the tax authorities

The SRS has established a separate central team specialising in TP issues. If regional tax auditors face a difficult TP issue or if their decision is appealed, then they may seek assistance from the central TP team.

Revised assessments and the appeals procedure

If a tax audit has resulted in an additional liability, the taxpayer must pay it, together with any penalty, within 30 days of receiving a tax decision, or the taxpayer may challenge the decision by appealing to a) the Transaction Evaluation Commission within ten days after receipt of tax decision, or b) the superior official (i.e. the SRS director general) within 30 days after receipt of a tax decision. If the taxpayer does not agree with a decision of the Transaction Evaluation Commission or the SRS director general, the decision may be taken to court.

Legal cases
Until recently, Latvia had no established TP practice as the Latvian tax authorities are still experiencing a learning curve in this field. In the last few years there have been some court cases dealing with disputes between taxpayers and the SRS relating to TP issues. Due to the increasing number of TP investigations over past year, the number of cases brought before the court is expected to increase.

Risk transactions or industries
In the absence of developed TP auditing practices, there is no particular industry or transaction having any larger TP risk than others, qualifying for exemption, or governed by stricter rules than others.

However, transactions involving a related provider of services, especially management services, or intellectual property are more likely to be scrutinised. These transactions typically are challenged on the grounds that the underlying contracts or other supporting documents are inadequately formalised or the tax auditors require proof of services being received and of benefit to the taxpayer.

It is frequently forgotten that in transactions with any entity located in a low-tax jurisdiction, TP rules should be applied.

Recent cases show that tax authorities tend to challenge the TP adjustments of taxpayers, even if the TP documentation is in place.

Liaison with customs authorities
The SRS is the main body for tax administration and customs' authority. Therefore, there are no obstacles to cooperation and information exchange between tax authorities and customs' authorities.

Joint investigations
The SRS practises information exchange with foreign tax authorities in line with Latvia's DTAs. However, there is no publicly available information about the results of joint investigations that took place as a result of information exchange.

Comparison with OECD Guidelines
Latvia is not yet an OECD member, but has committed to join the OECD in the foreseeable future.

While the arm's-length principle and Latvian TP rules have been borrowed from the OECD Guidelines, the SRS reserves the right to not guide itself by its principles, given that Latvia has not officially joined the OECD. Nevertheless, in practice, taxpayers commonly use the OECD Guidelines in selecting and applying methods for determining the arm's-length price or value.

Latvia

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Lebanon

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Overview

Lebanon does not currently have specific transfer pricing (TP) guidelines, although it does prescribe to use of the arm's-length principle. Like many Middle Eastern countries, Lebanon has a relatively low corporate tax rate at 15%.

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Country	Lebanon
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Documentation is not mandatory.
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	20% of the difference between tax due and tax declared and 1% of the unpaid tax/month

Lebanon

Introduction

The introduction of the Tax Procedure Law (TPL) No.44 in Lebanon (effective 1 January 2009) brought certain provisions regarding the treatment of related-party transactions from a Lebanese perspective. As part of this introduction to the treatment of related-party transactions, form and substance are acknowledged as well as certain fair market value concepts for evaluating such related-party transactions.

Until 1995, the only existing double tax treaty (DTT) was with France. As of December 2013, Lebanon had entered into DTTs with 29 countries and is currently in negotiation with 15 additional countries.

Although the TPL does not acknowledge the use of advance pricing agreements, the TPL has introduced the possibility of receiving advance rulings for transactions or operations based on the following cumulative conditions:

- The activity has not been completed yet.
- It is a concrete activity.
- Details of the activity should be advised.
- Clarifications are required.
- The tax administration may ask for additional information.
- The tax administration should answer in writing within two months.
- The ruling is binding to both parties if complied with.
- A fixed fee will be applied.

Legislation and guidance

On 11 November 2008, the Lebanese Parliament enacted the TPL No.44, which became effective 1 January 2009. The implementing regulations related to the TPL provide further guidance on the scope and condition of its application.

The general objective of the TPL is to improve the tax administration's work and to maintain (or establish) taxpayers' rights. Despite its purely administrative nature, as part of its income tax law, the TPL specifies an anti-avoidance rule that stipulates that when profits have been shifted abroad by deviating from 'normal' prices and conditions, such prices will be adjusted and added back to the taxpayer's taxable profit in Lebanon.

Moreover, the tax administration has the right to modify the value and conditions of transactions between related parties based on the arm's-length principle. The tax administration has the right to reclassify the transaction in either of the two following cases:

- A fictitious transaction, defined as a transaction where the value of a transaction differs by 20% (less or more) from the fair market value.
- A transaction that is legal in its form, but lacks the necessary economic substance.

According to Article 10 of the TPL, parties are considered related if one party has control and supervision over the other, i.e. one party has managing authority over the other party, which gives the former party financial and economic influence over the latter party from a regulatory perspective. Article 4 of Decision 453/1 further specifies that parties are considered related if they demonstrate:

- supervision and orientation powers
- a subordination relationship
- a tutorship relationship, or
- are jointly liable partners.

Moreover, Article 4 of Decision 453/1 provides concrete examples, when supervision and orientation powers are deemed to exist including:

- In case a physical or moral person possesses the majority of the capital leading to a majority of the voting rights or leading to the ability to nominate more than half of the company's board of directors.
- In case a physical or moral person is entitled by the company's board of directors to take decisions concerning the financial, economic and organisational (administrative) management of the company, even if not possessing more than 50% of its capital.
- Possession by a person of more than 50% of the company's parts.
- Person holding the right to obtain more than 50% of the partnership's profits.
- One person owning many enterprises.
- Many related persons owning more than one enterprise.
- The husband, wife, brothers, sisters, adult and minor descendants are considered as one person concerning the determination of the 'related persons' status for tax purposes.

Penalties

Every corporation has to submit its tax return by 31 May following the year of assessment. The Lebanese tax system is based on self-assessment. The tax authorities have the right to audit the tax return and may raise additional assessments and may apply penalties (e.g. the penalty for the incorrect tax declaration, which according to Article 110 of the TPL is 20% of the additional tax due). The incorrect declaration also leads to interest payments, because the additional tax should have been paid earlier (i.e. at the original filing date). According to Article 55 of the TPL, 1% on the additional tax (plus penalties) per month must be paid.

Documentation

The Lebanese tax laws and regulations do not contain a specific documentation requirement. However, during a tax audit the tax inspector may ask if documentation has been prepared or if a TP policy exists within the taxpayer's group.

Transfer pricing controversy and dispute resolution

The burden of proof lies first with the taxable person concerning its tax declaration. If the tax administration aims at additional assessments, the burden of proof shifts to the tax administration.

Lebanon

Comparison with OECD Guidelines

Although Lebanon is not an Organisation for Economic and Co-operation Development (OECD) member, it acknowledges the importance of the OECD Guidelines as international best practice. Transfer pricing set-ups that are based on other guidelines (e.g. UN) are accepted as long as they obey to the arm's-length principle.

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Libya

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Overview

Libya currently does not have specific transfer pricing (TP) law or guidelines. In addition, there is no recognition of a group for taxation purposes in Libya. Corporate Income Tax is levied on taxable profits at a flat rate of 20%.

Country	**Libya**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the Organisation for Economic Co-operation and Development (OECD) Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	No
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	No
TP documentation	
Can TP documentation provide penalty protection?	No TP documentation requirements
When must TP documentation be prepared?	No TP documentation requirements
Must TP documentation be prepared in the official/local language?	No TP documentation requirements
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No TP documentation requirements
Do penalties or fines or both apply to branches of foreign companies?	No TP penalties
How are penalties calculated?	No TP penalties

Libya

Introduction

Libya currently does not have any recognition of a group for taxation purposes. Accordingly, there are no TP guidelines governing intragroup transactions for multinational companies operating within Libya. However, the tax authority has the right to assess tax on a deemed profit basis under the general anti-avoidance provisions.

Legislation and guidance

There is currently no TP legislation and guidance in Libya.

Penalties

Every corporation has to submit its tax return within four months of its year-end or within one month of its audit report, whichever is earlier. Corporate income tax is payable on a quarterly basis. A late payment penalty is assessed on the tax due at the rate of 1% to a maximum of 12%. The remaining quarterly payments are due immediately for failing to make an instalment on time. There are no specific TP penalties in Libya.

Documentation

There are currently no TP documentation requirements in Libya for multinational companies.

Transfer pricing controversy and dispute resolution

There is currently no TP audit and dispute resolution process in Libya.

Comparison with OECD Guidelines

There are currently no TP guidelines in Libya.

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Lithuania

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Overview

There have been no recent changes in the Lithuanian transfer pricing (TP) legislation, which is generally in line with the Organisation for Economic Co-operation and Development's (OECD) practice. The detailed TP requirements (methods, documentation, etc.) are stipulated by Order No 1K-123 of the Minister of Finance of the Republic of Lithuania, dated 9 April 2004. The recommendations for the taxpayers issued by the State Tax Inspectorate (STI) on 24 September 2007 are mostly based on the OECD Guidelines.

As of 1 January 2012, taxpayers in Lithuania have a possibility to apply for an advance pricing agreement (APA) from the tax authorities in respect of future transactions. The first APA has been applied for and issued by the tax authorities in 2014.

The first TP-related court case in Lithuania has taken place at the end of 2013. The Supreme Administrative Court of Lithuania confirmed that the taxpayer had been purchasing metal production from the related parties at prices above the market prices. The taxable profit of the taxpayer was adjusted and, furthermore, interest on tax due and additional penalties were applied.

Country	**Lithuania**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Mostly
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No

Lithuania

Country	Lithuania
When must TP documentation be prepared?	There is no deadline for the preparation of the TP documentation; however, it should be submitted within 30 days upon the request of the tax authorities.
Must TP documentation be prepared in the official /local language?	TP documentation can be prepared in a foreign language; however, it should be translated at the request of the tax authorities.
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No (however, there are penalties upon the adjustment of taxable income)
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of both the adjustment to taxable income and the adjusted tax due.

Introduction

The arm's-length principle was introduced in Lithuania by the Corporate Tax Act of 20 December 2001. Little attention was paid to TP before this time. The detailed TP requirements (methods, documentation, etc.) are stipulated by Order No 1K-123 of the Minister of Finance of the Republic of Lithuania, dated 9 April 2004. OECD Guidelines have been carried over into Lithuania's domestic TP legislation, although in a more condensed form and with a somewhat clearer stance on a number of questions.

Further guidance and interpretation of the Lithuanian TP legal acts are provided in the TP recommendations for the taxpayers, issued by the STI on 24 September 2007, which rely closely on the OECD Guidelines as well. Recommendations address various issues regarding interpretation and application of Order 1K-123, such as selection and application of the most appropriate TP method, the process of comparability analysis, etc.

The supplemented Lithuanian TP rules, i.e. the Order 1K-123, should be issued in the near future.

As of 1 January 2012, there is the possibility of taxpayers in Lithuania applying for an APA from the tax authorities in respect of future transactions. The first APA has been applied for and issued by the tax authorities in 2014.

Legislation and guidance

Statutory rules

The definition of related parties includes, *inter alia*, i) members of a group consisting of a parent and one or more of its 25% or greater subsidiaries, ii) two entities if one of them directly or indirectly controls more than 25% of the shares in the other entity, or has the right to more than 25% of voting rights of the other entity, or has an obligation to coordinate its business decisions with that entity, or is under an obligation to third parties for the obligations of the entity, and iii) two entities where one has the right to make decisions that bind the other. The term 'associated parties', to which TP rules also apply, covers all entities that may influence each other in such a way that arm's-length pricing may not be achieved.

Documentation is required of a taxpayer if its turnover is greater than 2.896 million euros (EUR) per year. However, there is no such exemption for financial and insurance companies. In addition, the taxpayer has to prepare TP documentation for all transactions with the associated parties, regardless of their materiality.

Calculating an arm's-length price

Under Lithuanian TP legislation the Lithuanian tax authorities accept all methods outlined in the OECD Guidelines, with a preference for the application of traditional methods. The tax authorities would look to apply the comparable uncontrolled price (CUP) method to establish a market price for transactions.

The transactional net margin method (TNMM) is accepted; when applied, local comparable companies are preferred. However, practically, regional comparable companies are accepted if the number of local comparable companies is insufficient.

Lithuanian regulations neither specify the use of the full nor interquartile range when calculating an arm's-length range. In addition, they do not state how often comparable company sets should be updated.

Nevertheless, as per the recent court case, the tax authorities requested a taxpayer to use the interquartile range instead of the full arm's-length range in the benchmarking study, and the Supreme Administrative Court of Lithuania agreed with such position.

Reporting related-party transactions

An appendix to the annual corporate income tax (CIT) return must disclose the amount of the inter-company transactions, a description of the transaction and the parties to it, and the method used.

This appendix discloses the annual figures of the controlled transactions regarding each of the related parties (with which transactions have been conducted). If the value of the transaction is less than EUR 90,000, such disclosure is not necessary.

Risk transactions or industries

At present, the most notable risk transactions are those involving various types of services, management fees or financial instruments. The local tax authorities usually challenge interest-free or low-interest loan transactions. There are a number of benefit tests, and emphasis is placed on demonstrating the actual performance of a service.

Management services
Management services fall under particular scrutiny as historically, over the past 15 years, they have been seen by investors as simply a repatriation tool that does not require the legal procedures of a dividend and also offers a tax deduction. Tax authorities lacked the resources and commitment to challenge this practice effectively. For this reason, shared service centres and headquarters are facing increased documentation burdens, and Lithuanian finance personnel are increasingly reluctant to take responsibility for the effects of any such charge, sometimes even adding it back for tax purposes, regardless of substance.

The law specifically states that taxpayers should demonstrate that services were actually rendered, normally meaning objective tangible evidence such as reports or travel documents. There is also a benefit test, which appears to be an either/or rather than a cost-to-benefit comparison. Duplication of services is not permitted, which may inadvertently lead to difficulties in services that support or build on existing resources. Also of note is the non-deductibility of costs related to services that are deemed to arise from merely being a participant in a group, possibly referring to the benefits of centralised purchasing and similar functions, although there is yet little practical experience of how this rule would be applied.

Thin capitalisation
Very broadly, interest on debt exceeding a 4:1 debt-equity ratio is disallowed (unless it can be proved that an unrelated party would have lent at higher gearing). Debt from persons who on their own or together with related parties own directly or indirectly 50% of the payer is considered. For the purposes of the calculation, year-end balances are used (unless the tax authorities deem these unrepresentative), and the definition of equity is the balance on the last day of the tax period, excluding the financial result of the period and certain revaluation reserves. Interest from unrelated banks is not subject to thin capitalisation restrictions, unless an associated enterprise guarantees the debt.

Advance pricing agreements
As of 1 January 2012 taxpayers in Lithuania have a possibility to apply for an APA from the tax authorities in respect of future transactions. There are no fees applicable for the application. The tax authorities have 60 days for the examination of the application; an additional 60 days are added if the application requires additional examination. The decision made is valid for the current and following five financial years from the date it was taken by the tax authority, which must comply with the decision, while for the taxpayer it is not obligatory. The first APA has been applied for and issued by the tax authorities in 2014.

Penalties
There is a penalty of between 10% and 50% of the unpaid tax for incorrect declaration, the exact amount being discretionary. A penalty may be limited if there is no overall loss to the state budget, for example through a corresponding adjustment. In addition, there would be penalty interest calculated as 0.03% of the unpaid tax per day (valid from 1 October 2012).

At present, there are no penalties for failure to comply with documentation rules, but this may change.

Documentation

Documentation is required for all of the financial and insurance companies as well as the remaining taxpayers if their annual turnover is greater than EUR 2.896 million. TP documentation is required for all of the transactions with the associated parties, regardless of their materiality.

The requirements for TP documentation are outlined in section 10 of the STI recommendations.

To meet the documentation requirements for taxpayers conducting transactions with related parties, entities must include the following information when preparing their documentation:

- Information regarding the parties of the transaction, which would reveal their economic and legal relationship.
- Terms and conditions of the transaction (flows of financials and intangible assets, relevant agreements and correspondence, etc.).
- Description of the subject of the transaction.
- Distribution of the functions performed, risks assumed and assets owned by the parties of the controlled transaction.
- Economic analysis (selection of the most appropriate TP method, reasons for rejection of the preferred TP methods, comparability analysis, financial analysis).
- Any other information relevant to the transaction, e.g. analysis of the relevant industry, business strategies of the parties concerned, etc.

There is no deadline for the taxpayer to prepare the TP documentation; however, it should be provided within 30 days upon the request of the tax authorities. The documentation does not need to be prepared in the Lithuanian language; however, it should be translated at the request of the tax authorities.

Transfer pricing controversy and dispute resolution

Burden of proof

By law, the tax authority needs to make a case for an adjustment. In practice, however, it is often the case that a comparatively simple opening argument results in the taxpayer having to make substantial effort to build a defensive case.

Tax audit procedures

Tax audits are more likely following a refund claim, a tip-off or liquidation. The tax authorities primarily choose to audit the TP of companies that have incurred taxable losses for a few years and have substantial volume in international transactions. There are two types of procedures: limited and full. Either procedure can cover either a specific tax or the whole range of taxes. There is a standard 90-day time limit on the duration of any investigation, although this may be extended. There is a five-year statute of limitations.

Revised assessments and the appeals' procedure

The appeals' process is firstly to the officer conducting the investigation, then to a more senior person at the tax office, followed by the commission for tax disputes and finally the courts. In practice, however, most disputes over reasonably grounded differences in interpretation are settled in compromise without litigation.

Joint investigations
At present, there is no indication that Lithuanian tax authorities are involved in projects in which specific TP information is exchanged with foreign tax authorities. However, there is exchange of information with foreign tax authorities in projects related to other tax issues.

Resources available to the tax authorities
There are only a few persons specialising solely in TP within the tax authorities. This indicates that the authorities are not as experienced as many other European Union tax authorities. There have been comparatively few public statements or high-profile investigations to date.

The authorities have direct access to the Amadeus database. They focus on adjustments to internal CUPs including analysis of margins and mark-ups on transactions between the taxpayer and unrelated parties. However, they are already reviewing benchmarking studies as well. Lithuania is not an OECD member, and local rules allow the use of secret comparables in certain cases

Benchmarking study
Our experience shows that the tax authorities very thoroughly test benchmarking studies in terms of comparability of activities, financial data (e.g. operating revenue or fixed assets) and functions performed by the transactional parties, taking into account industry sector, independence and geographic location.

Legal cases
There has been a first court case in Lithuania on TP matters in 2013. The benchmarking study of the taxpayer was challenged, in particular, inclusion of holding companies as well as companies incomparable in terms of activities performed and/or assets owned and usage of the full range instead of interquartile range. As such, the corresponding arm's-length range was recalculated by the tax authorities. The Supreme Administrative Court of Lithuania confirmed that the taxpayer, while conducting controlled transactions, purchased metal production from the related parties at prices that were too high. The taxable profit of the taxpayer was adjusted (the gross profitability of the taxpayer was adjusted up to the average figure of the gross margins within the interquartile range) and, furthermore, interest on tax due and additional penalties were applied.

Comparison with OECD Guidelines
Lithuania is not yet an OECD member, but has committed to join the OECD in the foreseeable future.

Lithuania follows the OECD Guidelines closely with respect to interpretation of double tax treaties. However, for TP purposes, local rules take precedence in the event of conflict with the OECD Guidelines. A few examples are the usage of secret comparables, which are permitted by local legislation in certain cases as well as a strict regulated hierarchy of the TP methods with preference to the traditional methods.

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Luxembourg

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Overview

Luxembourg has recently made the arm's-length principle explicit in its local law. On 19 of December 2014 a new general transfer pricing (TP) legislation (the Law of 19 December 2014) was introduced with the aim to comply even more with the internationally accepted TP principles.

Country	**Luxembourg**
OECD member?	Yes
Transfer pricing legislation	
Are there statutory transfer pricing documentation requirements in place?	Yes
Does transfer pricing legislation adopt the OECD Guidelines?	Yes
Does transfer pricing legislation apply to cross-border inter-company transactions?	Yes
Does transfer pricing legislation apply to domestic inter-company transactions?	Yes
Does transfer pricing legislation adhere to the arm's-length principle?	Yes
Transfer pricing documentation	
Can transfer pricing documentation provide penalty protection?	Yes
When must transfer pricing documentation be prepared?	When submitting tax return. However, TP documentation should only be presented upon request of the Tax Authorities.
Must transfer pricing documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with transfer pricing documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes

Luxembourg

Country	Luxembourg
How are penalties calculated?	Potential adjustments result in penalties of 0.6% per month on the tax assessed.

Introduction

In 2011, the Luxembourg tax authorities issued two circulars on TP for Luxembourg-based entities that are mainly engaged in intragroup financing activities (i.e. intragroup lending activities financed by borrowings).

Recently, the Law of 19 December 2014 further formalised legislation on TP in Luxembourg and introduced TP documentation requirements for any type of intra-group transactions. The new TP rules take effect as from 1 January 2015.

Legislation and guidance

The statutory rule on TP is found in Article 56 of the Luxembourg Income Tax Law (LITL) which has recently been restated by the Law of 19 December 2014. The new Article 56 LITL reads as follows:

"When an enterprise participates, directly or indirectly, in the management, control or capital of another enterprise, or where the same individuals participate, directly or indirectly, in the management, control or capital of two enterprises and where, in either instance, the two enterprises are, within their commercial or financial relations subject to conditions made or imposed which differ from those which would be made between independent enterprises, the profits of these enterprises are to be determined under conditions prevailing between independent enterprises and taxed in consequence."

Whereas under the previous Article 56 LITL, the concept of related parties was broadly defined (i.e. special economic relationship), the new legislation outlining the arm's-length principle became more aligned with the Organisation for Economic Co-operation and Development (OECD) Tax Model Convention. One consequence is that the arm's-length principle is to be applied in transactions between two related entities both located in Luxembourg, as well as where one party is taxed in a foreign jurisdiction.

Moreover, the new text should in effect oblige the taxpayer to report in its tax return an adjustment of profits whenever transfer prices do not reflect the arm's-length principle. It is expected that further guidance on the application of the new Article 56 LITL may be introduced by way of a Grand-Ducal Regulation.

Furthermore, if a shareholder receives an advantage from a company which the shareholder would not have received if there had not been a shareholding relationship, then this could be characterised under article 164 of the LITL as a hidden distribution. This might occur in a case where a shareholder charged a Luxembourg company significantly more than the market rate for a service provided by the shareholder. Such a hidden distribution would result in an add-back to the taxable profits of the Luxembourg company, and also possibly an obligation to account for withholding tax (WHT) on the deemed distribution. The rate of WHT on a hidden distribution of dividends is 15% of the gross amount received (therefore, 17.65% of the net amount),

unless reduced under the application of a double tax treaty (DTT) or the European Commission (EC) Parent-Subsidiary Directive. An abnormal advantage granted by a Luxembourg shareholder to an affiliate could be seen as a hidden contribution and taxed at the level of a Luxembourg subsidiary. However, profits corresponding to such hidden contribution could still be deductible against relevant accounting year expenses and offset against losses carried forward.

On 28 January 2011, the Luxembourg tax authorities issued Circular L.I.R. n°164/2 (the circular) providing guidance on intragroup lending activities financed by borrowings. In the context of the circular, two enterprises are deemed to be related where one enterprise participates directly or indirectly in the management, control or share capital of the other, or if the same persons participate directly or indirectly in the management or in the share capital of both companies. The term 'intragroup financing transaction' refers to any activity consisting of granting loans or cash advances to related companies.

The scope of the circular applies to entities that are 'principally' engaged in intragroup financing activities. The circular, however, does not provide guidance on when an entity is 'principally' engaged in intragroup financing activities. The circular further states that an arm's-length remuneration should be determined for a Luxembourg entity carrying out such intragroup on-lending transactions in accordance with OECD Guidelines. A functional analysis is to be carried out to determine the remuneration of each entity, based on the functions performed and taking into account the assets used and risks borne.

Moreover, the circular mentions that a company should have sufficient equity to assume the risks in connection with its financing transactions and that such equity should be effectively used if the risk related to the financing materialises. The minimum equity at risk should amount to 1% of the nominal value of the granted financing or 2 million euros (EUR).

In addition to the equity requirements, companies falling under the scope of the circular are also required to satisfy certain substance requirements in order to be considered to have real substance in Luxembourg.

On 8 April 2011, the Luxembourg tax authorities issued an additional circular (L.I.R. n°164/2bis) to clarify the application of Circular L.I.R. n°164/2. This additional circular clarifies that confirmations obtained by the tax authorities before 28 January 2011 regarding the arm's-length nature of intragroup financing activities will no longer have effect as from 1 January 2012. Taxpayers must comply with the requirements set out in the 28 January 2011 circular (L.I.R. n°164/2) and file a request in this respect with the Luxembourg tax authorities.

Penalties

A local tax inspector (there is no central Luxembourg team of TP auditors) can scrutinise all transactions of all sectors of business and have the power of investigation including requesting information from third parties. Should such an audit result in an amendment of the taxpayer's tax return, the burden of proof is reversed and it will therefore be up to the taxpayer to prove the arm's-length nature of the transaction targeted by the tax authorities. Potential adjustments could result in penalties of 0.6% per month on the tax assessed for the taxpayer. However, there is a very limited experience of litigations.

Documentation

The Law of 19 December 2014 introduced a separate measure in the General Tax Law (*Abgabenordnung*) that made explicit the need for documentation for any type of intra-group transactions, by providing that the existing law on documentation requirements 'shall apply accordingly to transactions between related parties'. This new subparagraph hence clarifies that normal disclosure and documentation requirements also apply to transactions between related parties.

The Luxembourg tax authorities may request from the taxpayer all facts relevant for verifying a tax liability. For this purpose, the taxpayer is required to provide all necessary supporting documentation to facilitate the task of the Luxembourg tax authorities. The new subparagraph makes it clear that this obligation to provide documentation is applicable when the Luxembourg tax authorities are seeking to verify transfer prices.

The Commentary on the text of the bill that led to the Law of 19 December 2014 confirms that one consequence of this change is that, whenever the Luxembourg tax authorities have reason to consider that a transfer of profits might have occurred (because the transaction under analysis does not comply with the arm's-length principle) and the facts are not made clear or documented by the taxpayer, the Luxembourg tax authorities may look to the underlying economic reality of the operations and presume that there has been an undue reduction in profits, without having to justify this exactly. Hence, the absence of proper TP documentation could result in a reversal of the burden of proof towards the taxpayer.

No explicit documentation requirements are imposed. The Commentary on the text of the bill that led to the Law of 19 December 2014 notes that the nature and extent of the documentation needed depends on the circumstances of the case under consideration. It notes that, in principle, the expectation of the level of documentation needed should be lower for straightforward corporate transactions, or for those undertaken by small businesses.

Lastly, the Commentary on the text of the bill that led to the Law of 19 December 2014 points out that Chapter V of the OECD Transfer Pricing Guidelines – referred to here as being the 'directing principles relating to documentation' – are being revised. Hence, once the revision of Chapter V is completed it may be expected that taxpayers will need to apply the 'three-tiered' approach to documentation, which will include country-by-country reporting obligations, deriving from Action Point 13 of the OECD's BEPS Action Plan. The current version of the new Chapter V is set out in its entirety in the September 2014 OECD report *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*. This will not become fully finalised and effective until the OECD BEPS project is completed at the end of 2015.

Transfer pricing controversy and dispute resolution

A recent Luxembourg court case in which the arm's-length interest rates applied by a Luxembourg company were scrutinised demonstrates that the Luxembourg tax authorities increasingly focus on cross-border transactions, especially for companies that are mainly involved in intragroup financing transactions. Therefore, it is recommended that taxpayers carefully evaluate and substantiate the pricing of their intragroup financing activities through proper TP documentation.

Most of the tax treaties concluded by Luxembourg provide for an exchange of information procedure and contain mutual agreement procedure provisions.

With the law passed on 24 April 1993 and subsequent amendments, Luxembourg approved the adoption of the EU Arbitration Convention and follows the EU Council Code of Conduct for the effective application of the arbitration convention.

With the Law of 19 December 2014, a revised and unified system for advance tax confirmations was introduced in Luxembourg. This system includes any form of Advance Pricing Agreement (APA), whether covered by the scope of the 2011 Circular relating to financing activities, or otherwise. The aim remains to provide taxpayers with legal certainty for their transactions, while offering a uniform and egalitarian treatment between taxpayers and, importantly, increasing the transparency of the Luxembourg tax system. Filing fees, of a maximum of EUR 10,000, will apply to cover the administrative and operation expenses of the tax administration. The written confirmations are limited to five years.

Luxembourg companies are required to make their annual accounts publicly available by filing a copy with the local court. However, the accounts do not necessarily provide much information on potentially comparable transactions or operations because they do not normally contain detailed financial information.

Comparison with OECD Guidelines

The revised TP measures that were introduced in Luxembourg with the Law of 19 December 2014 should be seen as an extension and clarification of the current tax law, with change being made in order to make explicit the application within Luxembourg of the OECD concepts of TP.

Luxembourg

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Madagascar

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Overview

In Madagascar, transfer pricing (TP) regulation was set up by the Financial Act 2014. This is a new area of focus for the tax administration. The TP rules provides general information to be supplemented by circulars, which will provide more guidance on its application.

We believe that in the coming fiscal year, the tax administration will strengthen the legislation and the expected TP audits.

Country	**Madagascar**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No formal acceptance of the rules
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Not defined. TP documentation must be available upon request from the tax authority.
Must TP documentation be prepared in the official/local language?	Yes in French or Malagasy
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes (for penalties only)
How are penalties calculated?	A fixed amount and a percentage of any tax payment.

Madagascar

Introduction

Until recently, Madagascar did not have proper TP guidelines, but instead broad anti-avoidance rules, applicable to every sector, in order to prevent related parties pricing transactions in a manner that manipulates profits. The Finance Act for 2014 introduced the TP provisions in Madagascar, directly inspired from the Organisation for Economic Co-operation and Development (OECD) TP guidelines. The impact on Malagasy companies is important as it requires taxpayers to prepare appropriate documentation to comply with Malagasy requirements and to mitigate the tax exposure.

As from 1 January 2014, the Malagasy tax code includes a new writing of its Article 01.01.13, which now mentions:

- arm's-length principle
- taxation basis adjustment, and
- favourable tax treatment territory.

According to said rules, the companies and multinational groups should determine the price of their internal transactions according to the arm's-length principle. Failure to comply with the arm's-length principle may lead to a taxation basis adjustment in the Malagasy company's profits. The taxation adjustment basis may also apply if the Malagasy company is engaged in commercial or financial transactions with a company based in a favourable tax treatment territory.

There are currently no provisions in the Malagasy tax code for obtaining an advanced pricing agreement (APA). In practice, nothing prevents the taxpayer from engaging in discussions with the tax authorities to try to obtain an APA. This behaviour can help in the case of an investigation from the tax authorities to show the taxpayer's intent to comply with the Malagasy tax rules.

Legislation and guidance

The General Context:

Article 01.01.13 I of l the tax code provides that:
"For the purpose of profit tax payable by entity engaging commercial or financial transaction with associated company located outside of Madagascar, the calculation of taxable profits must comply with the arm's-length principle. This principle is acquired when the conditions of these transactions are not different from those which would be made between independent enterprises engaging in similar transactions under similar circumstances.

When conditions made or imposed in commercial or financial transactions between associated enterprises do not comply with the arm's-length principle, the benefits that would be realized by the company without these conditions and related taxes that the company would pay, but that could not be realized because of these conditions, can be added back to the taxable profits and taxed accordingly, that is to say subject to tax adjustment.

The provisions in the preceding two paragraphs shall also apply when a company located in Madagascar makes one or more commercial or financial transactions with a company, whether associated or not, established in a foreign state or territory with preferential tax treatment".

The specific context:
The implementation of the Madagascar legal provisions on TP is clarified by circular N°0004/MFB/SG/DGI of 24 January 2014 related to valuation, for tax purposes, compliance with the arm's-length principle as well as the application method for the specific provisions related to TP. The circular provides the following definition:

- **Associated companies:** two companies with a direct or indirect participation in the management, control or capital of either one of the two companies, or by the same, natural or legal, person(s); this participation is required either if the direct or indirect possession to the capital is over 25% or the effective capacity of taking decisions is noticed. Consequently, independent companies are companies that are not associated with each other.
- **Controlled transactions:** transactions between associated companies.
- **Transaction on free markets:** transactions between independent companies.
- **Transfer pricing:** price invoiced by a company for the transfer of movable goods, intangible assets or provides services to associated companies as part of cross-border operations.
- **Conditions for a transaction:** financial indicators, which can be the price, the margin on the resale price, the margin on costs, the net income or the distribution of the profit between the parties.
- **Favourable tax treatment:** tax treatment in a state or foreign territory where the company is not liable to tax or is liable to corporate or income tax equivalent to half or less of the corporate or income tax, payable if the company was subject to Malagasy tax law.

With respect to the arm's-length principle, the following methods can be applied:

- Comparable uncontrolled price (CUP).
- Resale price method (RPM).
- Cost-plus (CP) method.
- Transactional net margin method (TNMM).
- Transactional profit split method (PSM).

Taxpayers can select the method most appropriate to the facts and circumstances of the case. It is not required or necessary to use multiple methods for a given transaction.

In the event there is a variance between the price calculated in accordance with one of the above methods and the actual price of the transaction, the taxpayer must adjust taxable income for the purpose of its annual income tax return.

The variance can also be found by the tax authority as a result of a tax audit. In that case, the taxpayer will be subject to a tax adjustment.

Penalties

There are no specific TP penalties under the Malagasy tax code. The general provisions relating to offences and penalties are fully applicable.

A non-exhaustive list of penalties relating to the Malagasy general tax code provisions is set out below:

- MGA 100,000 fine for any violation of laws and regulation. (Article 20.01.56)
- MGA 100,000 fine for failure to file any document, or other accounting documents within the allocated time. (Article 20.01.52)
- Errors and omission lowering the tax base in any periodic or occasional reporting is subject to a fine equal to 40% of the amount due. In case of corrupt practice or opposition to tax inspection, the penalty is increased to 80% and 150% if there is opposition to the tax investigation. (Article 20.01.54)
- Late declaration of taxes is charged at a fine of 1% per late month with a minimum of MGA 2,000. (Article 20.01.53)
- Default to respond to tax investigation leads to a compulsory taxation based on the tax authority evaluation. (Article 20.03.04)

Furthermore, the circular OO4/MFB/SG/DGI of 24 January 2014 provides that failure to comply with the arm's-length principle in case of transactions with a company, whether associated or not, established in a foreign state or territory with preferential tax treatment leads to non-deductibility of the transaction in total, in the calculation of the income tax of the company located in Madagascar.

Documentation

According to Article 20.06.08 of the Malagasy tax code, a taxpayer must keep records of transfer pricing documentation and provide them to the tax authorities in the case of a tax audit and upon request. Such documentation must include the following information:

1. The nature of the relations between the company and one or several enterprises, companies, or a group operating or located, overseas.
2. The method used to determine the price of the industrial, commercial or financial transactions made between the enterprise and the enterprise companies, or group of companies mentioned in (1) and the elements that proved the agreed compensation.
3. The activities of the companies or groups mentioned in (1), relating to the operations mentioned in (2).
4. The tax treatment to the operations mentioned in (2) and made by its own companies operating overseas or the companies or groups mentioned in (1), in which it holds, directly or not, the majority of the capital stock or voting stock.

As a general rule, taxpayers must document the process and analysis followed in determining the arm's-length principle in compliance with the TP regulations.

Transfer pricing controversy and dispute resolution

As mentioned above, TP rules are new and have just been adopted through the Financial Act 2014. Such rules are still incomplete and do not provide full guidance on how tax audits will be performed.

We expect that, starting from January 2015, during a tax audit, the tax administration will focus their audit on examination of TP documentation and verification of the TP method(s) applied.

In the absence of any provision allowing taxpayers to conclude a unilateral APA with the Malagasy tax authorities, taxpayers must expect to have a strong discussion with tax authorities during the TP documentation audit.

Comparison with OECD Guidelines

Madagascar is not an OECD member country. However, considering the arm's-length principle, the provisions of the Circular N°0004/MFB/SG/DGI of 24 January 2014 issued by the tax authority in respect of the methods for determining arm's-length prices are similar to the OECD principles.

Madagascar

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Malaysia

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Overview

Transfer pricing (TP) has always been a key area of focus for the Malaysian Inland Revenue Board (IRB). Following the introduction of the Income Tax (Transfer Pricing) Rules 2012 and revised Malaysian Transfer Pricing Guidelines, there has been a significant increase in TP audits, and requests for documentation and submissions of multinational enterprise (MNE) forms from the IRB.

Following the increase in audit activity, the IRB issued a TP audit framework, which took effect on 1 April 2013. The framework sets out the audit process, and outlines the penalty structure applicable to additional tax payable as a result of TP adjustments.

On 7 November 2013, the Special Commissioners of Income Tax (SCIT) also decided on one of the first TP cases in Malaysia, MM Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (KPHDN). Although the case is currently under appeal to the High Court, the SCIT's ruling still provides some initial guidance on how the courts are likely to deal with TP issues in Malaysia.

With effect from the year of assessment (YA) 2014, taxpayers are required to confirm whether TP documentation has been prepared with the inclusion of a new checkbox (Box R4) in the income tax return (Form C) for YA 2014.

Country	**Malaysia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Upon filing of the company's tax return

Malaysia

Country	Malaysia
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Penalties computed on additional tax payable

Introduction

Malaysian TP legislation is broadly based on the arm's-length principle outlined in the Organisation for Economic Co-operation and Development (OECD) Guidelines. Prior to 1 January 2009, the IRB leveraged on a general anti-avoidance provision in the Income Tax Act, 1967 (ITA), Section 140, to impose TP adjustments on transactions deemed not at arm's length. The Malaysian Transfer Pricing Guidelines was subsequently introduced in 2003 to provide additional guidance to taxpayers on complying with the arm's-length principle from a Malaysian TP perspective.

Formal TP legislation was introduced, effective 1 January 2009. Section 140A empowers the Director General to make adjustments on transactions of goods, services or financial assistance carried out between related companies based on the arm's-length principle. The Income Tax (Transfer Pricing) Rules (TP Rules) were introduced on 11 May 2012 (with retrospective effect from 1 January 2009), and outline specific requirements to demonstrate compliance with the arm's-length principle from a Malaysian TP perspective.

Section 138C (effective from 1 January 2009) allows taxpayers with cross-border transactions to apply to the IRB for an advance pricing agreement (APA). The detailed requirements and process for APA applications are outlined in the Advance Pricing Arrangement Guidelines 2012 (APA Guidelines), which was issued on 20 July 2012.

Malaysia has a wide treaty network. Taxpayers who suffer additional tax from TP adjustments may apply to the IRB for tax relief under mutual agreement procedures (MAPs) under double tax agreements (DTAs).

Legislation and guidance

The key provisions of Section 140A can be summarised as follows:

- Section 140A(2) requires that the arm's-length price be determined and applied where a person enters into a transaction with an associated person for the acquisition or supply of property or services.
- Section 140A(3) allows the Director General to substitute transfer prices that are not arm's length for any related-party property or services acquired.
- Section 140A(4) allows the Director General to disallow any interest, finance charge, or other consideration payable for losses suffered in respect of all excessive inter-company financial assistance in relation to fixed capital, thereby introducing the concept of thin capitalisation.

The TP Rules were introduced on 11 May 2012, with retrospective effect from 1 January 2009. The Rules apply to controlled transactions for the acquisition or supply of property and services, and specifically address the method and manner in which compliance with the arm's-length principle should be demonstrated.

The IRB issued the Malaysian Guidelines on 20 July 2012. The Guidelines provide detailed guidance to taxpayers on how to comply with the requirements of Section 140A and the TP Rules.

The salient features of the TP Rules and Malaysian Guidelines are further discussed in the following paragraphs.

Meaning of 'control' and 'associated persons'
The Malaysian Guidelines refers to the definition of 'control' in Section 139 of the ITA, which defines control as both direct and indirect control. The Guidelines further refer to Section 2(4) of the ITA, where a 'controlled company' is one having not more than 50 members, and is controlled in the manner described by Section 139, by not more than five members.

The Guidelines have a wider definition of 'associated enterprise' than the ITA. Under the Guidelines (in paragraph 5.2), "two enterprises are associated enterprises with respect to each other if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise; or the same persons participate directly or indirectly in the management, control or capital of both enterprises".

Scope of the Malaysian Guidelines
The Guidelines are applicable to controlled transactions where at least one party is chargeable to tax in Malaysia, i.e. cross-border and domestic-related party transactions are within the scope of the Guidelines. The Guidelines (in paragraph 3.4) also cover transactions between a permanent establishment (PE) and its head office or its other related branches.

Thresholds
The Guidelines (in paragraph 3.1) have introduced a threshold to ease the compliance burden on taxpayers. The thresholds are as follows:

- Gross income exceeding 25 million Malaysian ringgit (MYR), and total amount of related-party transactions exceeding MYR 15 million.
- For financial assistance, the Revised Guidelines are only applicable if the financial assistance exceeds MYR 50 million. Financial assistance rendered by financial institutions is excluded from the scope of the Guidelines.

The thresholds do not apply to PEs.

Taxpayers that fall beneath the thresholds may opt to prepare simplified TP documentation or detailed TP documentation.

The Guidelines need not be applied to domestic controlled transactions, only where it can be proven that any TP adjustments made under Section 140(a) will not alter the total tax payable by both parties.

Comparability analysis

Tested party

In performing a comparability analysis, the IRB generally does not accept foreign tested parties where information is neither sufficient nor verifiable.

Comparable period

The arm's-length price should be determined by comparing the results of the controlled transactions with the results of uncontrolled transactions on a year-on-year basis.

The period used should be comparable, e.g. when assessing the results of a tested party for the financial year ended 31 March 2010, data for the financial year 2009 for a comparable company with a financial year-end of 31 December would be more comparable than data for the financial year 2010.

Separate and combined transactions

Transfer prices should ideally be set on a transaction-by-transaction basis. However, the Guidelines recognise that where transactions are so closely linked (or continuous) that they cannot be evaluated on a separate basis, determination of a TP based on bundled transactions may be considered. In such cases, the Guidelines require taxpayers to demonstrate that it is normal industry practice to set one price for a combination of transactions, or that there is insufficient reliable data to set the price for each transaction individually.

Recharacterisation of transactions

Under the TP Rules, the IRB may recharacterise a controlled transaction where:

- the economic substance of the transaction differs from its form
- when viewed in totality, the arrangements made in relation to the controlled transactions differ from that which would have been adopted by independent persons behaving in a commercially rational manner.

Losses

Taxpayers are expected to maintain contemporaneous documentation to justify that losses incurred are commercially realistic, and is not a result of their controlled transactions.

Business restructuring

The IRB recognises that it is commercially rational for a multinational group to restructure in order to obtain tax savings. However, a reduction in profits is acceptable only if the taxpayer is able to justify that there is a reduction in the level of functions performed, assets employed and risks assumed. As such, taxpayers undertaking business restructuring exercises should ensure that defence documentation is prepared to justify a reduction in profits.

Specific transactions

The TP Rules and Malaysian Guidelines provide specific requirements when applying the arm's-length principle in relation to the following specific transactions.

Intragroup services
The IRB regularly scrutinises payments of management fees/intragroup service fees to parent companies or affiliates. Under the TP Rules, taxpayers with intragroup service fee payments are required to justify:

- that intragroup services have been rendered, and that the taxpayer has received the benefits from these services, and
- that the charge for the intragroup services is at arm's length.

The TP Rules also state that an intragroup services charge will be disregarded if it involves:

- shareholder activities
- duplicative services
- services that provide incidental benefits or passive association benefits, and
- on-call services.

The Guidelines further clarify the exclusion of on-call service charges, by stating that there are exceptional circumstances where on-call services could be considered as chargeable services. However, it must be proven that an independent person in comparable circumstances would incur the charge to ensure that availability of such services when the need for them arises.

The Guidelines state a preference for the direct charge method when charging for intragroup services. However, where the direct charge method is impractical, the indirect charge method may be used. Taxpayers should ensure that the allocation key used is appropriate to the nature and purpose of the intragroup service. The analysis undertaken in arriving at the choice of allocation key(s) must be documented.

The IRB will not accept sales as an allocation key, unless the taxpayer can justify the correlation between sales and the costs incurred in providing the service/benefits derived from the service.

Cost contribution arrangements
Cost contribution arrangements (CCAs) are defined under the Guidelines as a framework agreed among business enterprises to share the costs and risks of developing, producing and obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights.

In practice, if a service arrangement does not result in any property being produced, developed or acquired, the principles for dealing with intragroup services will apply even if the arrangement has been described as a CCA.

Allocation of costs in a CCA must be made at arm's length. In addition, where there is an entry, withdrawal or termination by a party in a cost contribution payment, there should be payments made to the relevant parties based on the arm's-length value of the transferred interest/reallocation of interests in the CCA.

Intangible properties
Where the legal ownership of an intangible property does not vest with the person who developed the intangible property, the developer should receive an arm's-length consideration for the development of such property. Under the Guidelines, this could be in the form of a cost reimbursement plus an arm's-length mark-up, or lump-sum compensation equal to the value of the intangible property if the developer bore all the expenses and risks associated with the development.

Where the person who is not the owner of a trademark or trade name undertakes marketing activities (and bears the costs and risks associated with these activities) in excess of an independent comparable person, the person should be entitled to an arm's-length share of the intangible-related returns from the owner of the trademark or related intangibles.

Intragroup financing
Under the TP Rules, the IRB may impute/adjust the interest rate on intragroup financing transactions if the interest rate is not at arm's length. The Guidelines consider the comparable uncontrolled price (CUP) method to be the most reliable method to determine the arm's-length interest rate. When determining the arm's-length interest rate, appropriate indices such as the Kuala Lumpur interbank offered rate (KLIBOR), prime rates offered by banks and/or specific rates quoted by banks for comparable loans can be used as reference points. Adjustments are then required on those rates to arrive at the arm's-length interest rate applicable to the intragroup financing transaction under review.

Penalties
Tax adjustments as a result of a TP audit are subject to penalty under subsection 113(2) of the ITA. The IRB's TP audit framework outlines the following penalty rates for additional tax payable arising from TP adjustments:

	Penalty rate		
Condition	**Normal case**	**Voluntary disclosure after taxpayer has been informed, but before commencement of an audit visit**	**Voluntary disclosure before case is selected for audit**
If there is no contemporaneous TP documentation	35%	30%*	15%*
If TP documentation is prepared, but not according to requirements in the Guidelines	25%	20%	10%
If taxpayer does not fall under the scope of the Guidelines, and has not prepared contemporaneous TP documentation**	25%**	N/A**	N/A**
Taxpayer prepared comprehensive, good quality, contemporaneous TP documentation in accordance with prevailing regulations	0%	0%	0%

*Taxpayer is still required to prepare TP documentation upon voluntary disclosure.
**Not addressed in the IRB's TP audit framework; applicable rates are as specified in the Malaysian Transfer Pricing Guidelines.

Documentation

The TP Rules require taxpayers to prepare contemporaneous TP documentation to justify the arm's-length nature of their related-party transactions. Taxpayers are required to state if this requirement has been complied with in their annual tax returns from YA 2014 onwards.

In addition, section 82 of the ITA requires taxpayers to maintain appropriate documentation to support their transactions. Such records must be retained for a period of five years.

To comply with the contemporaneous documentation requirement under the TP Rules, taxpayers should have TP documentation in place upon:

- developing or implementing a controlled transaction, and
- where the transaction is reviewed and there are material changes, the documentation should be updated prior to the due date for furnishing the tax return for that year of assessment.

Transfer pricing documentation is not required to be submitted with the taxpayer's tax return. However, the documentation should be made available to the IRB within 30 days of the IRB's request.

The Malaysian Guidelines provide a list of documents required to comply with contemporaneous TP documentation requirements. The list, however, is not meant to be exhaustive, and the IRB could request for more documents, depending on the specific circumstances of the taxpayer.

The list of documents required under the Guidelines is as follows:

- Organisation structure (including the taxpayer's group organisational structure, and the taxpayer's organisational chart).
- Group financial report.
- Nature of the business/industry and market conditions.
- Details of the controlled transactions (e.g. parties involved, nature, terms and pricing).
- Pricing policies.
- Assumption, strategies and information regarding factors that influenced the setting of pricing policies.
- Comparability, functional and risk analysis.
- Selection of the TP method.
- Application of the TP method.
- List of APAs entered in by members of the group with respect to transactions to which the taxpayer is a party.
- Documents that provide support for the taxpayer's TP analysis, and
- Other relevant documents/information such as official publications, studies, market research, technical publications, agreements and correspondence.

Transfer pricing controversy and dispute resolution

Legal cases

MM Sdn Bhd v KPHDN is one of the first TP cases to be decided by the SCIT. The case was decided in favour of the taxpayer, and is under appeal to the High Court.

In MM Sdn Bhd, the IRB imposed TP adjustments on the taxpayer's inter-company transactions for YA 1999 to YA 2005. The TP adjustments relate to:

- reinstatement of import and export commission rates charged by the taxpayer to its related parties for YA 2002 to YA 2005, on the basis that the reduction in commission rates from 2002 onwards are not at arm's length, and
- disallowance of deductions of business process improvement (BPI) payments, on the basis that these services have not been received for YA 1999 to YA 2005.

The SCIT found that the Malaysian Guidelines had no force of law. As Section 140A had not yet been introduced during the period under dispute, the IRB did not have the power to impose TP adjustments on the taxpayers' transactions for the relevant period. The SCIT accepted the TP methodology applied by the taxpayer in supporting the arm's-length nature of its related-party transactions, which was in accordance with the OECD Guidelines.

Burden of proof

Under the self-assessment system (SAS), the burden of proof lies with the taxpayer to clear any alleged non-compliance with TP legislation.

As such, in a TP audit or enquiry, taxpayers must be able to substantiate with documentation prepared in accordance to the Malaysian Guidelines that their transfer prices have been determined in accordance with the arm's-length principle.

Tax audit procedures

Form C

In submitting their annual tax returns (i.e. Form C for companies), all taxpayers with related-party transactions are required to complete Section N to declare their related-party transactions for the year in the following categories:

- Total sales to related companies in Malaysia.
- Total sales to related companies outside Malaysia.
- Total purchases from related companies in Malaysia.
- Total purchases from related companies outside Malaysia.
- Other payments to related companies in Malaysia.
- Other payments to related companies outside Malaysia.
- Loans to related companies in Malaysia.
- Loans to related companies outside Malaysia.
- Borrowings from related companies in Malaysia.
- Borrowings from related companies outside Malaysia.
- Receipts from related companies in Malaysia.
- Receipts from related companies outside Malaysia.

In addition, if the taxpayer is a controlled company, it must disclose the details of its five main shareholders in Part P of Form C. The information provided is used as one of the resources by the IRB in selecting whether the company is a potential for a TP audit

or tax audit. As the disclosure of related-party transactions is part of the taxpayer's income tax return, failure to properly disclose information on its related-party transactions could result in an incorrect tax return.

With effect from YA 2014, taxpayers are required to confirm whether TP documentation has been prepared with the inclusion of a new checkbox (Box R4) in the income tax return (Form C) for YA 2014.

Selection of companies for audit
The IRB has a Multinational Branch that carries out TP desk audits and TP field audits. A separate team under International Tax is responsible for APA/MAP and TP policymaking.

Transfer pricing/tax audits can be triggered by a number of factors, including:

- information disclosed in Form C
- outstanding tax enquiries
- sustained losses
- use of tax havens
- comparison of various financial ratios achieved by a similar company within the same trade or industry
- fluctuations in profits from year to year
- desk audit referrals
- poor compliance history
- third-party information
- company is in a specific industry targeted by tax authorities
- company is in the process of liquidation, and
- company has not been tax audited in the past five years.

Other relevant information from public sources, such as newspaper reports, can also trigger audits.

MNE and JCK Forms
The IRB issued the Form MNE (Pin 2/2012) (MNE Form) and Form JCK (TP/1/2011) (JCK Form) in July and December 2011. The MNE Form addresses cross-border related-party transactions, while the JCK Form addresses domestic related-party transactions.

These forms are sent to selected taxpayers and are generally required to be completed within 30 days. The IRB generally requests for completion of the MNE and JCK Forms for the last two to three years of assessment. These forms enable the IRB to use a more targeted approach in identifying taxpayers for audits based on the complexity of their related-party transactions, and the level of compliance with TP legislation (e.g. availability of contemporaneous TP documentation). The forms require taxpayers to disclose the following information:

- Information on related parties (names and locations of holding company, ultimate holding company and subsidiaries, and names of Malaysian affiliates).
- Quantum of related-party transactions (sale and purchase of finished goods, materials and other assets, receipt or payment of royalties/licence fees, receipt or payment of management fees, receipt or payment of research and development fees and other service fees, rental or leasing of assets, receipt and payment of interest and guarantee fees, and any other related-party transaction).

- Quantum of interest-bearing loans and trade credit provided/received, and quantum of interest-free loans provided/received. In addition to amounts borrowed or loaned during the year, the closing balance as at year-end is also required to be disclosed.
- Characterisation of business activity (e.g. toll, contract or full-fledge manufacturer).
- Industry code, which is relevant to the taxpayer.
- Whether the taxpayer has prepared TP documentation for the relevant year.
- Whether any business restructuring has occurred for the taxpayer or other related parties in the group in the last five years.

The provision of information and duty of the taxpayer to cooperate with the tax authorities
Under the ITA, taxpayers must retain sufficient records for a period of seven years.

The IRB has the right of full and free access to all buildings, places, books, documents and other papers for the purposes of enforcing the provisions in the ITA. The IRB may also make requests for information that should be reverted to by the taxpayer within a stipulated timeframe. Failure to furnish information within the timeframe may result in tax disallowances.

The audit procedure
As part of the SAS, the IRB is expected to carry out tax audits including TP audits, on taxpayers. One distinguishing factor under the Malaysian regime is that the TP review process tends to be carried out in conjunction with a field audit, whereby there is greater scrutiny of transactions, as opposed to the practice in other established countries where documentation review is generally carried out via a desk audit.

Desk audit
The TP audit process is generally initiated by a request for financial and management information, such as statutory accounts, tax computations, management accounts and TP documentation. The IRB carries out a review of these documents and decides whether a more detailed review is required.

In straightforward cases, the IRB corresponds with the taxpayer or requests a meeting to discuss any issues and work towards a closure of the case.

Field audit
If the IRB's initial findings from the desk audit warrant a field audit visit, the IRB informs the taxpayer accordingly of the purpose of its visit, the officers who will carry out the audit process, the duration of the visit and the documents that need to be made available for their review. Generally, field audit visits are carried out by four to six tax officers within a one-week period. The officers examine any financial documents, supporting documents and agreements that are linked to a taxpayer's business operations. As part of the field visit, the officers also conduct interviews with key personnel of the taxpayer's business to obtain a better understanding of the functional profile of the company and the pricing basis adopted. At the end of the field audit, the IRB summarises its initial findings and arranges for a follow-up meeting at its offices to discuss the case.

The IRB is cognisant of taxpayers' concurrent business obligations; therefore, the process is fairly structured, with a reasonable timeframe provided for the submission of documents and information.

Revised assessments and the appeals procedure
If a taxpayer is not satisfied with a TP adjustment or assessment, the available avenues of appeal mirror the normal tax appeal procedures. To appeal, the taxpayer must file an appeal with the IRB within 30 days of receiving the Notice of Assessment. This culminates in the IRB agreeing to the appeal or routing the matter to the Dispute Resolution Department and then the Special Commissioners. Failing at that level, the ultimate decision resides in the High Court (or Court of Appeal) if the taxpayer or the IRB so desire to proceed to such authority.

Before proceeding with the appeals' process, the taxpayer is required to pay the assessed tax and penalties.

An alternative avenue available to taxpayers via the double-taxation treaties (DTTs) is the MAP, which is a mechanism that caters to equitable tax treatment on transactions that involve multiple tax administrations. In some instances, multinational corporations (MNCs) recognise the need for the use of this type of dispute–resolution procedures to ensure the elimination of double taxation. Currently, Malaysia has concluded 75 DTAs, globally.

Resources available to the tax authorities
The MNC branch of the IRB has a team at its head office that specialises in TP audits. With the additional disclosure information requested in Parts N and P of the Form C, the IRB has information to make a reasonable selection of companies for a tax or TP audit. Additionally, the IRB digitises the information disclosed by companies in their tax returns. This electronic database of information allows the tax authorities to effectively identify companies for audit, conduct trend analyses of a company's results as well as benchmark the company's performance against its industry.

The majority of the tax officers have experience handling tax investigations and tax audits. The officers are continually updating their knowledge through dialogues with other tax administrations in the region, in addition to attending and participating in training conducted by foreign and international tax authorities/bodies, such as the OECD.

Use and availability of comparable information
In order to demonstrate that the pricing outcomes being examined are arm's length, a company must demonstrate, through adequate documentation, that the transfer prices meet the arm's-length test for Malaysian tax and TP purposes.

Tax authorities
The tax authorities usually obtain comparable information within their internal database. Each year, companies are required to submit their tax returns and other associated work papers to the tax authorities. This forms part of the internal comparable information available to the tax authorities as well as information obtained from other tax audits performed.

Taxpayers
As a starting point, the taxpayer should determine whether internal comparable information can be found within the company. In the event that internal comparable information is unavailable, the tax authorities expect companies to have carried out an external comparable study using local comparables. Only in the event that local

comparables cannot be found will the tax authorities consider overseas comparables on a case-by-case basis.

In carrying out the search for local comparable studies, taxpayers use public directories and databases. Most Malaysian companies (private and public), except for exempt private companies, must prepare audited accounts, which can then be obtained from the Companies Commission of Malaysia. The process of retrieval of such information is done manually and is therefore time-consuming.

In deciding the arm's-length price, the TP guidelines do not specify a preference for a single figure or a range of figures to be used. Therefore, the tax authorities have the flexibility to decide whether a single figure or use of a range of figures is appropriate in determining whether the taxpayer has adhered to the arm's-length position.

Risk transactions or industries
No particular industry is more at risk of receiving a tax audit than another. Past experiences indicate that once the tax authorities have had substantial success in a particular company or industry, other companies in the same industry have been targeted.

The tax authorities are beginning to focus on the following related-party transactions as part of their audit selection:

- Sales and purchases of goods, assets and services.
- Transfer and use of know-how, copyrights and trademarks.
- Loan and interest payments.
- Cost-sharing arrangements.
- Management and administrative fees.
- Unusual economic transactions and arrangements.
- Research and development expense allocation.
- Sale, purchase and other commission payments.

Other issues that may alert the tax authorities include:

- Reduction of profits in a post-tax holiday period.
- Losses made on the sale of products or assets to related companies.
- Physical delivery of goods and invoicing to customers that are performed by different group companies located in different tax jurisdictions.
- Consistent losses or very low profits compared with other independent comparables.
- Constantly fluctuating profit margins.
- Significant differences in sales or purchase prices on transactions between related companies and independent third parties.
- Frequent changes in prices on transactions between related companies.

As the Malaysian tax authorities gain more experience in dealing with TP matters, the taxpayers will need to be better prepared to defend their TP position with adequate documentation.

Limitation of double taxation and competent authority proceedings

In addition to the limited agreements dealing with the taxation of international traffic of ships and aircraft, Malaysia has a fairly extensive network of comprehensive DTAs modelled on the OECD convention.

Most Malaysian treaties have the automatic relief, and this is a standard article – not a limitation issue. Malaysia's treaties generally contain an 'Associated Enterprise' article and a MAP article.

Advance pricing agreements

The move towards setting up an APA programme in Malaysia needs to be initiated by a request from a taxpayer for a unilateral APA or a bilateral APA.

The tax authorities encourage taxpayers to apply for unilateral or bilateral APAs. In this regard, if any taxpayer is interested in applying for an APA, they can initiate discussions with the tax authorities.

Applicants and scope

A taxpayer who carries on a cross-border transaction may apply to the IRB for an APA in relation to its inter-company transactions under Section 138C of the ITA. This includes companies, partnerships, individuals, corporation soles and PEs.

The APA Guidelines outline the following requirements for applying for an APA:

- A taxpayer who is company assessable and chargeable to tax under the ITA (also includes PEs).
- Turnover value exceeding MYR 100 million.
- The value of the proposed covered transaction is:
  - for sales, if it exceeds 50% of turnover
  - for purchases, if it exceeds 50% of total purchases, or
  - for other transactions, if the total value exceeds MYR 25 million.
- All covered transactions must relate to income that is chargeable and not income which is exempted.
- In cases involving financial assistance, a threshold of MYR 50 million applies.

Process

The APA application process in Malaysia consists of five stages: (i) pre-filing meeting(s), (ii) formal submission, (iii) processing of the APA, (iv) signing, and (v) submission of annual compliance reports. A written request must be made to the IRB 12 months prior to the commencement of the proposed period of the APA. Pre-filing meetings are held between the tax authorities and the taxpayer to discuss the feasibility of an APA. The IRB notifies the taxpayer on whether it should proceed with a formal submission. A formal submission must be lodged with the IRB within two months of receiving the notification. The IRB expects the following information in a formal APA submission:

- Period covered by the APA (minimum of three years to a maximum of five years).
- Business model and industry information.
- Relevant details for related-party transactions to be covered.
- Functional comparability and economic analyses.
- The proposed TP methodology and critical assumptions upon which the methodology depends.
- Annual forecasts and business plans for the APA period.

APA monitoring and renewal

The taxpayer is required to file annual compliance reports subsequent to the conclusion of an APA with the IRB. The report should contain a copy of the taxpayer's audited financials, the covered inter-company transactions and a description of any material changes in the taxpayer's operations. If a mismatch exists between the taxpayer's actual prices and that in the APA, the taxpayer is required to provide details of any compensating adjustments required.

The APA may be revised in the event that the taxpayer fails to meet any critical assumptions in the APA with both parties' consent. An APA may also be revoked in cases of non-compliance by the taxpayer, or if the taxpayer makes any misrepresentations, fraud, omissions, or misleading or false statements.

Comparison with OECD Guidelines

Malaysia is not a member of the OECD. However, Malaysian TP legislation adopts the arm's-length principle and uses the TP methodologies endorsed by the OECD Guidelines. Under the TP Rules, preference is given to the traditional transaction methods, namely comparable uncontrolled price (CUP) method, resale price method (RPM) and cost plus (CP) method. However, the IRB has stated that this was primarily due to the fact that the TP Rules were drafted before issuance of the revised OECD Guidelines, and in practice, the best method approach outlined in the revised OECD Guidelines will be followed.

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Mexico

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Overview

Mexico did not apply international standards to its transfer pricing (TP) legislation until 1997. In December 1996, the Mexican Congress enacted significant tax reform, introducing the arm's-length principle, controlled foreign company legislation and other anti-avoidance measures. Several minor reforms regarding TP have been enacted since that time, and the detailed rules included in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines must be applied in Mexico, since Mexican Income Tax Law (MITL) specifically requires the application of these Guidelines to the extent consistent with the MITL and any applicable treaty. In addition, the Mexican TP tax authorities have become relatively sophisticated.

Country	**Mexico**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	When the tax return is filed
Must TP documentation be prepared in the official / local language?	Yes
Are related party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Please refer to penalties section of this chapter.

Mexico

Introduction

During 2013, Mexico faced a tax reform which introduced a new MITL starting in 2014. The new MITL eliminates some tax regimes and deductions (e.g., the tax consolidation regime, a percentage of tax-exempt employee benefits, etc.). A new 10% tax is imposed on dividends and the flat tax law was repealed. Most of those amendments went into effect on 1 January 2014.

The above-mentioned tax reform also includes certain unilateral actions taken to address initiatives being evaluated by the OECD concerning base erosion and profit shifting (BEPS) recommendations. Examples include, enactment of article 69-B of the Mexican Federal Tax Code (*Codigo Fiscal de la Federación*, [CFF]), which directly addresses substance issues related to inter-company transactions; certain MITL provisions disallowing deductions involving low-tax jurisdictions, transparent entities and disregarded transactions; and the requirement to file a new Information Return Regarding Relevant Transactions (Form 76). Form 76 requires taxpayers to provide information related to international transactions, TP adjustments, financial transactions related to derivatives, royalties, restructurings, and changes in capital structure and changes in taxpayer's business model.

Legislation and guidance

Most of the specific TP rules are included in Articles 76 (Sections IX, X and XII), 179, 180, 181, 182 and 184 of the revised 2014 MITL. These rules require taxpayers to produce and maintain documentation demonstrating that gross receipts and allowable deductions for each fiscal year arising from inter-company transactions are consistent with the amounts that would have resulted had these transactions taken place with unrelated parties under similar conditions. Moreover, documentation of the arm's-length nature of inter-company transactions should be determined on a transactional basis.

All inter-company transactions between related parties, including domestic and foreign-related parties, must be based on arm's-length prices for income-tax purposes, including transfers of tangible and intangible property, services, rental or licensing of assets, loans and transfers of shares (whether publicly traded or not), and applies to both domestic and foreign transactions entered into by individual and corporate taxpayers. The annual documentation requirements for inter-company transactions carried out with foreign-related parties are more extensive than for inter-company transactions performed between Mexican entities.

Taxpayers are required to determine their tax obligations and file returns on a calendar-year basis for income tax purposes. There is no specific deadline for preparing TP studies. Nevertheless, a Supreme Court case decision in 2007 held that the deadline to comply with the TP documentation requirement is the date the corporation files its income tax return (normally no later than 31 March of the following applicable calendar year), and failure to do so could result in the disallowance of deductions pertaining to payments to related parties. There are no sizeable immediate penalties in case of failure to prepare the documentation; however, there is an important penalty reduction inducing taxpayers to prepare contemporaneous documentation, which is covered in the penalty section below.

Moreover, the Federal Tax Code allows the option for some taxpayers to have their financial statements audited by a certified independent public accountant (CPA) in

Mexico. In those cases, the CPA files the audited financial statements with the tax authorities along with a statutory tax audit report (*dictamen fiscal*), that includes an opinion as to whether the taxpayer has complied with its federal tax obligations, which is usually required to be filed by or near 15 July following the end of the calendar year. All inter-company (domestic and cross-border) transactions should be disclosed in the appendix of the *dictamen fiscal*. If the TP documentation has not been prepared, such failure should be disclosed by the CPA in the *dictamen fiscal*.

Starting in 2011 and according to the modifications set by the tax reform from FY 2014, Mexican taxpayers that do not present the *dictamen fiscal* must indicate compliance with its tax obligations through the *Sistema de Información Alternativa al Dictamen* (SIPIAD). In this case, the taxpayer is effectively required to indicate that it has prepared the TP documentation.

The Tax Administration Service (TAS) may request the calendar year documentation as early as January of the following year, but in practice the documentation is not likely to be requested before the issuance of the *dictamen fiscal*. We are aware of situations in which the TAS has requested the TP documentation after the tax return was filed and before the *dictamen fiscal* is due, but this is unusual.

The TP documentation is considered part of the taxpayer's accounting records. The MITL imposes the obligation to maintain the documentation as part of the accounting records and to identify related party transactions with non-residents. As in the past, the TP documentation must be in Spanish and kept at the Mexican tax domicile of the taxpayer.

It should be noted that the annual TP documentation is not filed with the tax authorities. Rather, it must be prepared and maintained by the company, generally for a period of five years. In the case of an audit by the tax authorities, the taxpayer must make the TP documentation available upon request.

The MITL does not explicitly require taxpayers to prepare documentation regarding 'domestic' related party transactions, but these transactions must be reported on an arm's-length basis, and this is ordinarily proved, based on the preparation of a TP study. Consequently, in practice, it is considered that taxpayers must prepare TP documentation to establish comparability and the arm's-length nature of the domestic related-party TP transactions. If a CPA provides a *dictamen fiscal*, they ordinarily require taxpayers to provide them with the relevant documentation of domestic inter-company transactions before issuing the report.

The law defines related parties as parties that are directly or indirectly managed, controlled or owned by the same party, or group of parties. A permanent establishment (PE) and its home office, other establishments, and their related parties, as well as their PEs, are deemed to be related parties.

Unrelated taxpayers entering into a special contractual joint venture agreement known as an *asociación en participación* are also considered related parties for TP purposes in Mexico.

The tax authorities are entitled to make an adjustment if a taxpayer fails to comply with the obligation to report arm's-length amounts in the income tax return.

Article 180 of the MITL specifies the following six permissible TP methods:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus (CP) method.
- Profit split method (PSM).
- Residual profit split method (RPSM).
- Transactional net margin method (TNMM).

The above methods are consistent with the methods established in the OECD TP Guidelines.

The MITL applies a best method rule for all transactions between related parties. For this purpose, taxpayers are first required to consider the CUP method and may apply the other methods only if the CUP method is not appropriate. This effectively places the burden on the taxpayer to prove and document the reasons for not applying this method. The law also provides a second preference to apply the RPM and/or the CP methods, implicitly imposing the burden of documenting why these methods were not appropriate if a profit-based method is used. The law also clarifies that the RPM, CP and TNMM methods shall be considered as being met when it is established that both the revenue and costs are separately shown to be arm's length.

In addition to the obligation to pay income tax in accordance with the arm's-length principle, taxpayers have four important TP related obligations: to prepare and maintain annual TP documentation; to file an information return on transactions with non-resident related parties, generally with the timely filing of their income tax return for the previous fiscal year, as Appendix 9 of the DIM – multiple information return (information return); to meet special reporting requirements for the transfer of shares and quotas of Mexican companies between related parties; and starting in fiscal year 2009, the independent accountant has to complete three different questionnaires with very detailed TP questions in the *dictamen fiscal*. In addition, corporate taxpayers not filing a *dictamen fiscal* must separately file these questionnaires by 30 June after the end of the calendar year.

In line with the OECD initiatives concerning BEPS, the new 2014 MITL introduced the following rules, under which a number of disbursements are not deductible:

- Interest, royalty or technical assistance payments made to a party resident abroad, which controls, or is controlled by the taxpayer, when:
  - the company receiving the payment is considered to be transparent, except when the operation is carried out at market value and its stockholders or associates are subject to income tax on income received through the company located abroad
  - the payment is considered to be non-existent for tax purposes in the country in which the foreign party is located, and
  - the foreign company receiving the payment does not consider it as taxable income.
- Payments by a Mexican entity that are deductible by a related-party resident abroad; these payments are nondeductible in Mexico unless the related party abroad includes the related income in its own taxable income, in that period or in the following period.

Dictamen fiscal
The following taxpayers have the option to obtain the *dictamen fiscal*:

- Companies that obtained taxable revenue in excess of 100 million Mexican pesos (MXN) during the prior fiscal year (approximately 7.6 million United States dollars [USD]).
- Companies or groups of companies whose net worth (calculated pursuant to the Mexican Assets Tax Act) during the prior fiscal year exceeded MXN 79 million (approximately USD 6.1 million).
- Companies with at least 300 employees in every month of the prior fiscal year (1 January – 31 December).

Significant additional TP information is required to be disclosed by the CPA issuing the *dictamen fiscal.* These provisions are designed to require the CPA to take on more responsibility towards compliance with TP obligations and to help the tax authorities identify potential TP contingencies.

This miscellaneous rule requires disclosure of the TP methods in the *dictamen fiscal*, and the CPA must state whether the transaction was reflected on an arm's-length basis, whether a tax adjustment was made to comply with the arm's-length standard (specifying where it is recorded in the general ledger and in what part of the book tax reconciliation it is reflected), and a statement as to the tax year in which the transaction was registered as a cost, expense or income for accounting purposes. The miscellaneous rule also requires disclosure of the tax identification numbers of the individuals preparing or advising on the TP report for the applicable year (and incidentally the tax identification numbers of other tax advisers).

These rules require disclosure of information on advance pricing agreements (APA); favourable resolutions issued by the tax authority on inter-company transactions, affirmation of the existence or not, of TP studies for both domestic and international transactions, and an affirmation of previous filing of informative return on foreign-related-party transactions (Appendix 9 of the DIM).

Specific questions must be answered regarding the deduction of pro rata expenses from abroad, management fees, back-to-back loans, derivative financial transactions, thin capitalisation, *maquiladoras* with bonded warehouses, and the TP method applied for *maquiladoras* under Articles 181, 182 and 183 of the MITL.

The CPA is required to state whether the taxpayer owns or uses intangible assets and must specify the principal intangible assets it uses, grants, or owns. The CPA must state whether all of the inter-company transactions have been reflected in the accounting records.

Information return
Article 76, section X, establishes that all corporations and individuals engaged in business activities are required to file an information return on transactions with non-resident related parties. This information return is due on the same day as the tax return filing date, within the three-month period following the end of the calendar year for corporations, and by the end of April for individuals. Taxpayers that file a *dictamen fiscal* may file their information return along with it (referred to as Appendix 9 of the *Declaración Informativa Múltiple* [DIM] for its acronym in Spanish).

Appendix 9 of the DIM requires a confirmation of the existence of TP documentation for each inter-company transaction, the amount of the transaction, the type of transaction, the gross or operating margin obtained by the tested party for the transactions, the TP method used for each transaction, the taxpayer identification number of the related party, and the country of residence and address at the tax domicile of the related party.

Unlike the obligation to prepare TP documentation, all corporate taxpayers and individuals engaged in business activities must file this information return, irrespective of the amount of gross receipts. *Maquiladora* companies with a valid APA ruling from the TAS and those that comply with Articles 181, 182 and 183 of the MITL are not obligated to comply with such filing, but only for its *maquiladora* operations.

Failure to comply with this filing may result in fines and in the disallowance of the deduction of all payments made to non-resident related parties. Additionally, failure to file the Informative return must be disclosed in the *dictamen fiscal*. The fines range from MXN 61,000 to MXN 122,000 (approximately USD 4,700 to USD 9,300), and these penalties are in addition to those that could apply in case of a tax deficiency.

Because compliance is a requirement for the deduction of payments to non-residents and payments to resident-related parties are not subject to this requirement, it might be possible to argue that the disallowance of the deduction is inconsistent with the non-discrimination provisions of Mexico's tax treaties. (Mexico's tax treaties include a provision such as that in paragraph 4 of Article 24 of the OECD's Model Tax Convention on income and on capital). Nevertheless, it should be noted that the obligation to file remains in any case.

Both the *dictamen fiscal* and the information return are used by the TAS to identify and schedule TP audits.

Transfer of shares

Mexican law imposes income tax on income derived by non-residents on the sale of shares or quotas issued by Mexican resident companies. In this case, a special 'tax report' prepared by an independent Mexican CPA must be filed certifying compliance with tax obligations on the share or quota transfer unless the transaction is exempt under a tax treaty. This obligation applies even if the transaction qualifies as a tax-deferred reorganisation under domestic law.

The special 'tax report' on the alienation of shares must include a report on the value of the shares, and the CPA must state which valuation methods were taken into account, and why. For example:

- Inflation-adjusted capital of the entity.
- Present value of future cash flows (income approach).
- The last quote in case of publicly traded stock.

In the first case, the information must include details on the amount of the historical capital and the corresponding adjustments. In the second case, the regulations under MITL require detailed information on the name or names of the methods used for the discounted value of the cash flows, discount rates and the existence of residual values, the number of projected time periods and the economic sector of the company whose stock was alienated. In any case, the CPA is required to explain in the report,

the reasons for the selection of one of these three alternatives. Compliance with these provisions effectively requires a detailed appraisal of the company, and it should be noted that there is not a *de minimis* rule for small transactions or small companies. Moreover, a detailed tax basis calculation must be determined and opined on.

Legal cases

In 2014, the Mexican Supreme Court (SCJN) issued a resolution regarding the expenses incurred abroad by a Mexican company and allocated on a pro-rata basis with foreign related parties and stated that such expenses may be deductible as long as the expenses meet certain requirements, such as: (i) strictly indispensable standard; (ii) arm's-length principle; (iii) the Mexican company keeps information of the foreign related party; (iv) supporting documentation and (v) valid business reason.

Soon after the Supreme Court decision, the SAT issued a miscellaneous resolution providing that in order to allow the deduction of said expenses, it would be also necessary to demonstrate (i) the economic substance surrounding the transaction and economic benefit, (ii) evidence that demonstrates the effective rendering of the services, and (iii) the legal arguments of considering such expenses as a trade of business deduction.

Therefore, in the case of an audit carried on by the SAT, the allowance of the deduction of such expenses may be granted, based on a further analysis on a case-by-case basis.

Burden of proof

Assuming the taxpayer prepares and submits the TP study to the tax authorities upon request, the TAS generally has the burden of proof to demonstrate that the taxpayer failed to comply with its obligation to report arm's-length amounts in the income tax return. On the other hand, the burden is shifted to the taxpayer when no study is presented.

Any transaction with an entity resident or located in a low-tax jurisdiction will automatically be presumed to be a transaction with a related party and will also be considered not at arm's length. In these cases, the taxpayer has the burden of proof to demonstrate that the transaction was entered into with an unrelated party, or that the transaction was at an arm's-length price.

As a general rule, a tax assessment not challenged within the 30 working-day period becomes final. Under the competent authority procedure there is an exception to this time limit (*see explanation below*).

It should be noted that any notice of deficiency must state the facts on which it is based and the applicable law, and the TAS must include an explanation of how the law was applied to the facts. Failure to comply with these requirements will result in an invalid notice of deficiency by the tax authorities.

Use and availability of comparable information

Comparable information utilised to determine arm's-length prices should be included in the taxpayer's TP documentation. However, there is frequently little reliable public financial information available on Mexican companies. Therefore, after reviewing potential local comparables, reliance is often placed on foreign comparables with a proper evaluation of market adjustments.

The TAS has the power to use confidential information of third parties. However, the taxpayer has limited access to this data through two designated representatives who must agree to be personally liable to criminal prosecution if the data is disclosed.

Anticipated developments in practice
During recent years the International Tax Division and the Transfer Pricing Central Administration established important audit programmes, mainly to address the following tax issues: (i) intangible assets migration derived from corporate restructurings, (ii) profitability of presumed PEs, (iii) inter-company debt arrangements, and (iv) cross-border services that have been deducted as management fees or other services including issues concerning pro rata charges, proving services among others. These kinds of audit programmes are likely to increase. Some of the issues that will probably be included in the new programmes contemplate fees for technical services, commission payments and royalty payments. Controversial issues will probably include the use of multi-year averages for the tested party, the use of secret comparables and the protection of confidential information during court proceedings.

Limitation on deductions
As mentioned previously, the MITL 2014 reform starts to limit certain deductions in line with the OECD BEPS initiative, and there will be significant emphasis on these target companies considered as engaging in BEPS activities.

General transfer pricing concerns
Some taxpayers document their related-party transactions through the development of an aggregate profitability analysis (e.g. the US comparable profits method) while the TAS expects a transactional profitability analysis when using the TNMM operating profit analysis. Also, the lack of comparability in economic analyses and use of inappropriate profit level indicators (ROCE, Berry ratio, MOTC, etc.) are issues that TAS has disputed in its reviews.

The TAS is also challenging the taxpayer's failure to use internal comparables (e.g. CUP method) with appropriate adjustments, and the selection procedures used to accept or reject independent comparable companies, as in some cases the search cannot be replicated by TAS.

Specific transfer pricing topics
In the area of interest expense, the TAS is concerned about the lack of non-tax business reasons to enter into a loan. There is also concern that the loan may not be based on reasonable cash-flow expectations of the borrowing company and the TAS may seek to verify whether credit terms are comparable to those that would be agreed upon with, or between, independent third parties in a comparable transaction.

In terms of royalties, there is concern that there are companies paying royalties for intangible assets that are not used and do not generate a profit for the Mexican taxpayer. The TAS maintains that royalty payment must be consistent with the operation of the company and should be proportionate to (or commensurate with) the profit margin earned by the company and must be agreed, based upon the arm's-length principle.

In terms of inter-company service charges involving allocations (e.g. management fees, IT support) there is a concern that these fees typically use a mechanical or arbitrary calculation for the charge, as well as not meeting strictly indispensable standards for business expenses. In the past, *pro rata* allocations were considered non-deductible in Mexico; nevertheless as previously mentioned, during October 2014 specific rules were published in order to deduct these kinds of expenses as long as very specific requirements are met. Some of these requirements are: evidence of the services being provided to the Mexican entity; proof of a benefit received by the Mexican taxpayer; proof that expense is strictly indispensable (similar to an ordinary and necessary standard) for the taxpayer's business activities; that the person with whom the *pro rata* expenses are made, is a resident in a country with which Mexico has a broad exchange of information agreement, among others. The above follows TAS' concern that the services are not being provided and that a benefit is not being received. Moreover, there is close scrutiny to ascertain that there is no duplication of expenses and that stewardship expenses are not being passed down to the Mexican subsidiary.

In terms of local inter-company transactions, there is concern that not all companies are documenting the arm's-length nature of the transactions in a TP study. These transactions are being scrutinised.

In terms of reorganisation, the business reasons, exit taxes, disruption or cancellation payments, PE and foreign trade issues, among others, are being closely reviewed.

Penalties

Several consequences follow a TP adjustment. At the outset, an adjustment is made by making an assessment of the gross receipts and deductions that would have arisen in uncontrolled transactions. In cases where two or more comparables are found, a range will be used. The range must be adjusted using statistical methods, and the adjustment is made to the median of such a range. It should be noted that an adjustment by the tax authorities is possible, only if the prices used by the taxpayer or the margin in the controlled transaction are outside such a range.

As a consequence of the assessment, many tax attributes might need to be adjusted. For instance, if the adjustment turns losses into profits, the amount of net operating losses will decrease, and if the price of an inter-company transfer of a fixed asset changes, the depreciable basis in such property will change. Also, the foreign tax credit limitation may increase if the taxable income increases as a consequence of an adjustment to an international operation, and the amount of the net after tax earnings account (or CUFIN for its acronym in Spanish) will increase as a consequence of any increase to the taxable income. Withholding taxes and estimated payments also might require an adjustment.

Constructive dividends may be subject to a corporate level tax triggered in case the distribution does not arise from the CUFIN. The tax is calculated by applying the corporate tax rate to the amount of the TP adjustment grossed up by 1.3889 from 2007 to 2009 and 1.4286 from 2010 to 2014.

In addition to the aforementioned changes, the amount of the adjustment to the taxable income is itself often treated as a constructive dividend. Moreover, these may be an impact on value-added tax customs' duties.

There are no separate penalties applicable to TP tax adjustments. Instead, the regular penalties for failure to pay are regularly imposed. These penalties range from 55% to 75% of the inflation-adjusted amount of the assessment. The penalty is reduced to 50% if the payment is made during the audit and prior to the notice of deficiency. Where the amount of a loss is reduced, the penalty ranges from 30% to 40% on the difference between the reported and the actual loss, to the extent a portion of any portion of the misstated loss is utilised. Besides the penalties and the inflation adjustment, late payment interest (termed surcharges) also is imposed.

A 50% reduction in penalties is applicable if a Mexican taxpayer meets the contemporaneous TP documentation requirement. There are no rules designed to determine the degree of compliance with the documentation requirements.

Documentation

The documentation requirements in Article 76 section IX of the MITL include the following elements:

- General information such as the name of the company, address, taxpayer identification number, name of the related parties and a description of the taxpayer's ownership structure covering all related parties engaged in transactions of potential relevance.
- An overview of the taxpayer's business including an analysis of the economic factors that affect the pricing of its products or services, such as a description of the functions performed, assets employed and risks borne by the taxpayer for each type of transaction.
- A description of the controlled transactions and the amount of the transactions (including the terms of sale) for each related party on a transactional basis according to Article 179 of the MITL.
- A description of the selected methodology applied as established in Article 180 of the MITL including information and documentation of each type of inter-company transaction.

This annual documentation requirement does not apply to corporations and taxpayers engaged in business activities with annual gross receipts that do not exceed MXN 13 million (approximately USD 1 million) during the previous fiscal year. In the case of taxpayers providing professional services, the annual documentation requirement also does not apply if the gross receipts from those services do not exceed MXN 3 million (approximately USD 230,000). In any event, upon audit, these smaller taxpayers will still need to prove the inter-company transactions are at arm's length.

In general

The statutory rules have not been extensively regulated. Some rules deal with technical issues, such as the documentation that must be attached to an application for an APA. These requirements are discussed in detail in the APA section, below.

The regulations under the MITL require the use of the interquartile range for the resale minus, cost-plus and TNMM methods, and state that inter-company transactions will be deemed to be in compliance with the arm's-length standard if they are within that range, but if the taxpayer's price, amount of compensation, or profit margin is out of the interquartile range, the median of the said range shall be deemed the price or amount of compensation that would have been used by independent parties.

The maquiladora industry

Maquiladoras are mainly companies that assemble or manufacture using temporarily imported raw materials and components on consignment for subsequent export. Typically, a *maquiladora* uses machinery and equipment consigned by the non-resident using its services. The term *maquiladora* originally referred to a particular customs' regime, facilitating temporary imports and reducing costs for imports such as customs fees, value-added taxes, etc. However, this customs' regime was combined with another similar regime (PITEX) in 2006, and the new scheme applicable to both is now termed the IMMEX programme.

Maquiladora models according to Article 3 of the IMMEX decree are classified as follows:

- Controlled group: holding company and one or more subsidiaries.
- Industrial companies that have an industrial process of transforming goods for export.
- Services: companies that provide services related to the export or consulting services.
- Shelter: foreign companies that provide technology and raw materials without operating them.
- Outsourcing: performs contract or toll manufacturing operations through third parties registered in the IMMEX programme.

The *maquiladora* regime has helped Mexico become a strategic destination for investors, and has contributed to Mexico's strong position when compared to other low-cost labour territories.

Prior to 1995, *maquiladoras* were regarded as cost centres and were not required to report significant profits. However, since 1995, the Government has required *maquiladoras* either to report arm's-length profits or to meet a safe harbour. These alternatives were regulated by administrative rules, subject to annual renewal.

Failure to comply could result in a TP adjustment and the application of PE rules to the non-resident principal providing detailed instructions to, and exercising general control of, the *maquiladora*.

The tax reform in 2013 brought significant changes to the special TP rules for *maquiladoras*. Transfer pricing options for *maquiladora* companies are now provided in Articles 181, 182 and 183 of the MITL. Specifically, in order to obtain PE protection, service *maquiladoras* no longer qualify as a *maquiladora*, the *maquiladora* must physically or virtually export 100% of their production, *maquiladoras* must only receive inventory on consignment (i.e. not permitted to perform contract manufacturing), and at least 30% of the fixed assets used in the *maquiladora* must be owned by the foreign principal abroad.

Moreover, the MITL establishes that foreign companies operating through a *maquiladora* will not be deemed as having a PE in Mexico, provided that they are residents of a country that has a tax treaty in place with Mexico, that all the terms and requirements of the treaty are satisfied and, eventually, that the mutual agreements that Mexico and its applicable treaty partner may have are observed. This provision applies only if *maquiladoras* comply with any of the following TP options:

- Reports taxable income of at least the higher of the following values (safe harbour):
    - 6.9% of assets used in the *maquiladora* activity (including the inventories and fixed assets owned by the foreign-related party). Such value must be determined under the principles of the old Asset Tax Act, which requires inflation adjustments and takes into account the statutory depreciation rates. All the assets used in the *maquiladora* operation during the fiscal year must be taken into account for the calculation. The only assets that may be excluded from the calculation are those leased at arm's length to the *maquiladora* by a Mexican resident or a non-resident related party, except if they were previously owned by the *maquiladora*. Property leased at arm's length from related parties that used to be property of the *maquiladora* may be excluded only if the *maquiladora* disposed of the property at an arm's-length price. The value of assets used for *maquila* and non-*maquila* operations may be taken into account rateably, only with an authorisation from the TAS; or
    - 6.5% on operating costs and expenses of the *maquiladora*. The costs must be determined under Mexico's generally accepted accounting principles (GAAP) except for the following items:
        a. The total amount of purchases is used instead of the cost of goods sold.
        b. Tax depreciation is used instead of accounting depreciation.
        c. Extraordinary or non-recurring expenses (under Mexico's GAAP).
        d. Inflation adjustments.
        e. Financial charges.

      Both calculations are subject to a number of exemptions and special rules. The result of those special rules might differ significantly from the numbers in the books of the company.
- Request an APA before the tax authorities in terms of the Federal Tax Code. Tax authorities must be informed of an APA election according to the tax gazette.

Maquiladora companies must qualify with the definition of '*Maquiladora* Operation' established in the MITL in order to apply the TP regulations and benefits (article 181 MITL).

Additionally, on 26 December 2013, an industry presidential decree was published providing tax incentives as follows:

- *Maquiladoras* may apply a new tax benefit that provides an additional deduction relating to tax-exempt employee benefits' payments, thereby softening the effect of a new law otherwise limiting deductions for tax-exempt benefit payments.
- Taxpayers that complied with 216-Bis MITL1 as of 31 December 2009, in effect until 31 December 2013, will have a two-year period to fulfil the requirement of a 30% foreign ownership of the machinery and equipment (M&E) used in the maquila operation, meaning there will be a two-year grandfather clause for *maquilas* operating before 2010. Foreign M&E may not have been owned by the *maquiladora* or a related party before.

On 1 July 2014, the TAS published amendments to the Mexican miscellaneous rules in force for 2014. These amendments introduce certain changes and clarifications to the *maquiladora* regime, which could affect *maquiladora* entities that carry on certain auxiliary activities.

In general, the new rules introduce more flexibility to the concept of 'productive' income and allow *maquiladora* entities to engage in certain 'complementary' activities without jeopardising their qualified status. Allowed complementary income may be derived from the following activities:

- Employee services (lease of personnel).
- Leasing or sale of movable and real estate property.
- Disposal of scrap produced by 'maquila' operations.
- Interest income.
- Other income related to the 'maquila' operations, except for income from certain sales of finished goods.

To engage in such complementary activities, a *maquiladora* company must comply with various requirements, including:

- The total amount of income from these activities may not exceed 10% of the total income from 'maquila' operations.
- In the case of personnel leasing, employees may be provided only to related parties.
- The company must provide to the tax authorities, segmented information regarding complementary activities.
- On the sale of movable and real estate property, the company must file a notification that describes the business reasons that will exist after the sale.
- With respect to income derived from the lease of movable and immovable property to unrelated parties, the transaction must be concluded within three years from the date on which the transaction entered into force. There is an exception for agreements that entered into force before 1 January 2014, and specified a term longer than three years.

Safe harbour rules cannot be applied to 'other' complementary income.

Liaison with customs' authorities

The TAS is in charge of the enforcement of both tax and customs law. General tax examinations undertaken by the TAS include all federal taxes including income tax, value-added tax, assets tax and customs' duties. Therefore, values used for the purposes of payment of customs' duties and other customs' information are available for tax purposes. Similarly, any information submitted for tax purposes is also available for customs' purposes. During an onsite audit all aspects of taxation are usually reviewed by the same team (including customs' duties).

Thin capitalisation

Section XXVII is incorporated to Article 28 of the MITL, which establishes the procedure to be followed in determining the interest portion corresponding to loans that shall not be deductible.

For purposes of determining the annual average liabilities, all liabilities are now considered. The new rules clarify that the disallowance applies only to interest on debts with related parties resident abroad. The definition of related parties stated in Article 179 of the MITL is applicable. Moreover, the taxpayer can compare the liabilities multiplied by three, to either (i) the equity (following Mexican GAAP), or (ii) the sum of the tax basis equity accounts (Account of Contributed Capital or CUCA for its acronym in Spanish, plus the CUFIN balances).

When the debt of Mexican taxpayers exceeds three times its shareholders' equity, the interest generated by excess debt will not be deductible. In calculating the debt-to-equity (D/E) ratio mentioned above, the amount of the related and unrelated party loans contracted by the company must be considered, with the exception of certain mortgages.

The thin capitalisation rules are not applicable to companies belonging to the financial sector, which comply with the capitalisation rules pertaining to their sector.

Furthermore, Mexican entities that have an excessive D/E ratio due to loans with related parties can apply for an APA ruling from the TAS on the arm's-length nature of the loan in order to maintain the excessive ratio. An authorisation is also possible for excesses attributable to unrelated party loans, if the arm's-length nature of the taxpayer's operations with its related parties is also reviewed by the tax authorities.

These formalities to have the non-deductible excess interest waived will require the certification of an independent accountant.

Transfer pricing controversy and dispute resolution

Tax audit procedures

It is important to mention that there have been a relatively important number of recent, specific TP audits aimed at specific industries including pharmaceutical, retail, tourism, consumer products, financial services, pharmaceutical, automotive, energy, mining, construction, with relatively large settlements. The issues addressed in these audits are profit margins, portfolio sales to related parties, intermediate services, royalty payments, profitability of presumed PEs, deemed transfers of intangibles, deductibility of interest, guarantee fees and conventional payments, and government concessions. In recent times tax authorities are focusing on restructurings, conversions to limited risk (e.g., *maquiladora*) entities, loan arrangements, BEPS targets, and on services provided by foreign-related parties.

We should note that attorney–client privilege does not exist in Mexico. Although professional service providers are required by law to maintain confidentiality with respect to client information, this duty to maintain confidentiality does not apply when the law (under statutory authority) imposes the obligation to produce a report. In tax audits, the law states that the tax authorities may request all kinds of documents pertaining to the audit from the taxpayer, or third parties (including lawyers and accountants). In these situations, the general obligation to maintain confidentiality is overridden by a request made by the tax authorities.

Documents prepared in anticipation of litigation are not protected, but taxpayers and their advisers may refuse to provide documents that are not relevant to the tax audit.

In theory, TP may be reviewed using regular procedures; under this scenario the tax authorities would initiate the informal procedure through a summons of the company's CPA, and if the information provided is not sufficient, they would be able to apply any verification procedure established by the Mexican Fiscal Code including specific requests of information, onsite verifications, etc. The TAS has a specialised group, *Administración Central de Fiscalización de Precios de Transferencia* (General Administration of Large Taxpayers), which performs the TP examinations of large

taxpayers although there has been a recent trend for the international tax group to conduct transfer pricing audits.

Moreover, during an onsite examination, the taxpayer is under obligation to provide all the information that demonstrates compliance with tax obligations including TP documentation. Failure to comply with a request might trigger the disallowance of deductions, the imposition of fines or, in more grave circumstances, the imprisonment of the representatives of the company. However, it should be noted that during an onsite examination, taxpayers are merely under obligation to allow the examination to take place and to provide the books and records. Taxpayers are not required to produce special reports for the tax authorities, or to actively participate in the proceedings.

A taxpayer opposing a tax audit might be subject to a presumptive assessment or imputation of income. The tax authorities are also entitled to search the company's premises and seize the required information.

Outside the scope of the specific requests of information and the onsite tax audits, the tax authorities have broad power to obtain information from alternative sources including through one of the most effective ones used in recent times, the exchange of information with countries with whom Mexico has signed tax treaties.

If a taxpayer does not comply with an information request during an audit, the TAS may impose fines that range from approximately MXN 13,720 (approximately USD 1,055) to MXN 41,700 (approximately USD 3,210) and take other measures to secure the information.

During the examination, the TAS may request information and must be allowed access to the accounting records of the company. All findings must be documented and witnessed in writing. In the course of the examination the audit cannot be completed without providing to the taxpayer a written statement of findings.

It is legally possible to obtain and use information from foreign authorities without the permission of the taxpayer.

In TP cases, a two-month period must be allowed between the last partial written record (*última acta parcial* or *oficio de observaciones*), which is the first document of the examination made available to the taxpayer, and the final determination. A one-month extension is available upon request.

As a general rule, tax examinations must be completed within 12 months. This limit does not apply to certain audits including TP cases, which have a two-year rule. The statute of limitations on being able to make tax assessment is generally five years for all federal tax matters including TP cases. The running of the period is suspended during an onsite audit (no suspension applies in the case of other types of examinations), or if the taxpayer files a petition before the courts.

As part of the recent tax reform, a new programme was introduced into the Mexican Federal Tax Code as a way to conclude the tax audit process, known as Conclusive Agreement

The Conclusive Agreement procedure involves the taxpayer making a proposal to the Mexican Tax Authority (MTA) in order to settle the audit; however, this is a formal procedure that involves the Tax Ombudsman, an independent government agency, in which the taxpayer prepares the proposal and the Tax Ombudsman presents it to the MTA. The MTA has a 20 working day period to accept or reject the proposal. After the response of the tax authority the Tax Ombudsman has a 20-day period to close the procedure.

Revised assessments and the appeals procedure

A TP adjustment may be appealed before the tax administration (*recurso de revocación*), or a lawsuit may be filed before the Tax Court. It is not necessary to use the appeals procedure within the administration before going to the Tax Court. In either case, the taxpayer has a 30 working day term to appeal the determination by the TAS.

In some cases, the administrative appeal is not filed; since it is often considered that the TAS will not change its determination. Nevertheless, regarding TP issues, we have observed that the administrative appeals process could be a viable option that provides the taxpayer an additional opportunity to carry out further negotiations with the TAS; moreover, the taxpayer is not obligated to provide any kind of bond until the tax administration has reached a conclusion regarding the administrative appeal. This exception for payment of a bond also applies for competent authority procedures.

Please note that if the case goes directly to the Tax Court the taxpayer is required to provide a guarantee (bond, deposit and/or mortgage) for the amount of the deficiency and an estimate of the additions to the tax of one year.

The Tax Court is an autonomous administrative court of original jurisdiction. It is divided into sections that hear cases within its territory. One of its divisions (*Sala Superior*) is higher within the hierarchy and is in charge of important cases, regardless of territorial considerations. In any case, the Tax Court can only decide whether a determination by the tax authorities was made according to the law; therefore, it cannot change the amount of the adjustment made by the tax authorities or determine that a third alternative must be followed. The Tax Court will only affirm or reverse the assessment made by the tax authorities. The federal courts (Court of Appeals) may review judgments made by the Tax Court. The federal courts are vested with the authority to review legal and constitutional issues.

Determinations made by the courts are not binding except for the parties involved in the litigation. A holding by a court of law may become a mandatory precedent, only under limited circumstances (involving a reiterated position of the court) and even in such cases, it is mandatory only for lower-tier courts and not for the TAS. Individual court determinations may be treated only as a persuasive authority to those that were not involved in the case.

Within the Tax Court, there is no subject matter specialisation, and therefore, in principle, any division of the Court may hear a TP case. Nevertheless, the *Sala Superior* may decide to hear any case involving a business that exceeds five thousand times the annual minimal salary (approximately an amount of MXN 123 million [approximately USD 9.48 million]). It also has been pre-established that the *Sala Superior* will hear any TP case where the statute is construed or interpreted for the first time.

Limitation of double taxation and competent authority proceedings

Double taxation relief is granted by corresponding adjustments under tax treaties. Mexican law requires approval of the adjustment in order to allow the Mexican taxpayer to file an amended tax return. Should these conditions be met, a tax refund may be obtained. Under most tax treaties entered into by Mexico, the corresponding adjustment may be denied in case of fraud, gross negligence, or wilful default. Mexico has not implemented this rule.

The corresponding adjustment for domestic TP cases is not regulated. This means that taxpayers may elect to report the adjustment through an amended tax return for the year in question. However, it should be noted that there are certain restrictions on the filing of amended tax returns; one of them is the requirement to file the competent authority procedure established in Article 184 of the Income Tax Law.

Most tax treaties entered into by Mexico contain time limits for notice of a competent authority procedure (e.g. 4.5 years with the United States), and a ten-year period for the implementation of any agreement is usually included. In all cases it will be important to take into consideration the specific time limit included in the applicable tax treaty.

As a final step in the dispute resolution process between competent authorities of tax treaty countries, there is a possibility of an arbitration procedure. Although this is not presently mandatory, it could be a valid resource that should be evaluated.

Resources available to tax authorities

The Mexican Government has also implemented important institutional changes aimed to improve the efficiency of law enforcement. A specialised group usually performs TP audit examinations.

Taxpayers must submit significant information to the TAS in planning and conducting its examinations including the information return on payments to non-residents, the information return on main suppliers and clients, and the information return on international transactions between related parties.

Mexico is actively exchanging tax information and best audit practices with its treaty partners, especially with the United States. The exchange of information may be automatic, upon specific request or spontaneous in nature.

Joint investigations

The TAS is vested with the authority to participate in simultaneous tax examinations with another country under the exchange of information provisions included in tax treaties.

Advance pricing agreements (APAs)

APAs have been included in the law as a legal possibility since 1997. They are issued as unilateral 'rulings' under domestic law, or as bilateral determinations under the competent authority procedure. APAs approve a methodology and not a specific result. Pre-filing meetings on a no-name basis are possible. As of 2012, APAs covered up to five fiscal years: the current fiscal year, the three subsequent fiscal years and a one-year roll-back.

Bilateral APAs are also possible with treaty country residents under the competent authority procedure, and in these cases tax authorities are entitled to waive late payment interest. Bilateral APAs may be issued for more than five years because they are not subject to the limitations described above. Unlike rulings on international tax issues, the TAS is not required to publish APAs.

The law provides that APAs should be resolved in a maximum period of eight months. In practice, most APAs take longer.

The office in charge of APAs is the *Administración Central de Auditoría de Precios de Transferencia*. This is the same office that performs international examinations.

As anticipated above, under general rules issued by the TAS, the information and documentation requirements for an APA application are substantial:

- Power of attorney of the legal representative.
- Name of the company, tax domicile, tax identification number and country of residence of the taxpayer, and the person or persons with equity interest in the taxpayer.
- Certified copy of the corporate book of the taxpayer where the shareholders are registered.
- The names of the related parties in Mexico or elsewhere that have a contractual or business relationship with the taxpayer.
- A description of the principal activities including the place where the activities are undertaken, describing the transactions between the taxpayer and its related parties.
- Organisational chart of the group; must include shareholding percentages.
- Balance and income statement as well as a breakdown of costs and expenses incurred by the taxpayer for the three prior years to the period to be covered by the APA; or if taxpayer is under the obligation to file a *dictamen fiscal*, the audited financial statement with the report issued by the registered CPA.
- Tax returns of the taxpayer including amended returns for the past three years.
- Copy in Spanish of all the contracts and agreements between the taxpayer and its related parties (resident and non-resident related parties).
- Beginning and closing date of the fiscal years of the related non-resident entities with which a contractual or business relationship exists, or the indication that they use a calendar year.
- Currency used in the main transactions.
- The transactions to be covered by the APA.
- Detailed description of activities undertaken by the company and its related parties with which it has a contractual or business relationship including a description of the assets and risks assumed by such person.
- The method or methods proposed to determine the price or amount of consideration in transactions undertaken with related residents and non-residents including criteria and other elements for considering that the method applies to the mentioned transaction or company.
- Information on comparable transactions or companies, the adjustments made to the comparables, and the explanation of rejected comparables and adjustments.
- Financial and tax information corresponding to the fiscal years for which the ruling is requested, applying the method or methods proposed. (This requirement is basically a forecast of the financial statements and tax returns.)

- A disclosure stating whether the non-resident related parties are involved in a TP examination elsewhere. (It is also necessary to disclose whether the taxpayer's related parties have filed a legal remedy regarding a TP case, or if they have been involved in TP litigation. In case there is a final determination, the main points of the holding must be explained.)

The fee for an APA is MXN 11,644 (approximately USD 896). Once the APA is issued, an annual report must be filed with the TAS. The fee for the APA's annual review is MXN 2,329 (approximately USD 179). Should the critical assumptions change, the APA may be ended.

Recently, a number of important tax rulings have been conditioned to an APA.

Comparison with OECD Guidelines

OECD issues

Mexico is a member of the OECD and has accepted the revised recommendation of the council on the determination of TP between associated enterprises. In general, the Mexican TP rules are consistent with OECD Guidelines.

Under a reservation made on Article 9 of the Model Tax Convention on Income and Capital, Mexico reserves the right not to insert paragraph two (corresponding adjustment) in its tax conventions. However, most Mexican tax treaties provide for a corresponding adjustment if the adjustment made by the other state is arm's length.

As from January 2002, the OECD Guidelines are a mandatory interpretative source of the TP provisions of the Income Tax Act to the extent they are consistent with the MITL and tax treaties.

New OECD Guidelines

The OECD recently approved the 2010 version of its OECD Guidelines. Under the latest version of the OECD Guidelines, taxpayers in Mexico should expect to see increased challenges by the tax authorities with regard to the comparability of data used to support the TP analysis. The impact of the changes is also likely to be felt in the planning and implementation of TP policies.

In addition, a nine-step process has been added to the OECD Guidelines, which will need to be followed by taxpayers. In practice, taxpayers will need to have a process that is reliable and transparent, i.e. one that the TAS can examine, follow and test when necessary. Consequently, the OECD Guidelines may have an important impact on documentation for some companies in Mexico.

Finally, the tax authorities are adhering closely to the restructuring provisions in audit disputes.

Mexico

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Moldova

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Overview

The arm's-length principle has been set forth in Moldovan tax law since 1998. Transfer pricing (TP) regulations, however, are currently at an initial development stage. According to the 2015–2017 Medium Term Tax Policy of the Moldovan Government, as well as the available draft law, formal TP documentation requirements are expected to be introduced in Moldovan tax law in the near future.

Country	**Moldova**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	N/A
Does TP legislation apply to cross-border intercompany transactions?	N/A
Does TP legislation apply to domestic intercompany transactions?	N/A
Does TP legislation adhere to the arm's-length principle?	N/A
TP documentation	
Can TP documentation provide penalty protection?	N/A
When must TP documentation be prepared?	N/A
Must TP documentation be prepared in the official/local language?	N/A
Are related-party transactions required to be disclosed on the tax return?	N/A
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Introduction

Currently, TP regulations in Moldova are at an initial development stage. However, according to the 2015–2017 Medium Term Tax Policy of the Moldovan Government, as well as the available draft law, formal TP documentation requirements are expected to be introduced in the Moldovan tax law in the near future.

Limitation of double taxation and competent authority proceedings
The avoidance of double taxation principles is not expressly mentioned under the Moldovan tax law.

Nevertheless, taxpayers might benefit from more favourable tax regimes, which are provided in the double tax treaties (DTTs) concluded by Moldova with other countries. As of 1 January 2015, Moldova has 47 DTTs in force, which are based on the Organisation for Economic Co-operations and Development (OECD) Model Tax Convention on Income and on Capital.

The 'Associated Enterprises' article of the DTTs allows Moldovan Tax Authorities (MTA) to adjust taxpayer's taxable income if the transaction with its related party was not at arm's-length value. Note that the Commentaries to the OECD Model Tax Convention on Income and on Capital should be used by the MTA and taxpayers as a guidance on the interpretation of DTTs and, correspondingly, also for the purposes of the tax administration.

Advance pricing agreements (APA)
No APA or binding tax rulings are provided under the 2015 Moldovan tax law.

Legislation and guidance
As a general rule, under Moldovan tax provisions, transactions concluded between related persons are taken into consideration only if the interdependence of these persons does not influence the outcome of the transaction. The arm's-length principle applies to transactions with both resident and non-resident-related parties.

With reference to the transactions carried out by Moldovan companies with related parties, Moldovan tax law provides the following specific provisions:

- No deduction is allowed for losses incurred on the sale or exchange of property, performance of work or supply of services between related parties, carried out either directly or through intermediaries (regardless of whether the transaction price corresponds to the market value).
- No deduction is allowed for expenses incurred in relation to related parties if no justification is available for payments and if such expenses do not represent necessary and ordinary business expenses.

Besides transactions with related parties, taxpayers have to follow the market value for the following operations performed with third parties in non-monetary form:

- Alienation of capital assets.
- Granting donations.
- Non-qualified reorganisation of the company.
- Distribution of company profits.

Definition of related parties
In accordance with Moldovan tax law, a company is considered the taxpayer's related party if one of the following conditions exists:

- The company controls the taxpayer.
- The company is controlled by the taxpayer.
- Both the company and the taxpayer are under common control of a third party.

From a tax perspective, control is the ownership (either directly or through one or more related persons) of 50% or more in value of the capital or voting power of one of the companies. For this purpose, an individual will be treated as owning all equity interest that is owned directly or indirectly by members of his or her family.

Two individuals are related parties if they are spouses or relatives up to the fourth degree.

Transfer pricing methods
Moldovan tax law does not list any specific TP methods.

Penalties
Current tax law does not provide for any specific fines for the violation of TP regulations. However, failure to comply with TP rules may result in underreporting of corporate income tax (CIT) liabilities, which consequently triggers a fine of 30% (100% for tax evasion) of the diminished CIT liabilities.

Documentation
Formal TP documentation requirements are expected to be introduced in the Moldovan tax law in the near future.

Currently within tax audits, taxpayers might be required to present proof that the related-party transactions are performed at the market price.

Transfer pricing controversy and dispute resolution

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Burden of proof
Currently, Moldova has no formal TP documentation requirements. Nevertheless, domestic tax law provides that taxpayers have the burden of proof over the arm's-length value of transactions with related parties.

Legal cases
We are aware of a legal case brought in front of the Supreme Court of Justice, when MTA challenged the deductibility of expenses by claiming a violation of the arm's-length principle. In this specific case, MTA performed a TP adjustment by applying the comparable uncontrolled price method. However, the taxpayer argued that he was not a related party to the service provider during the period when the service agreement was valid. The Court held the taxpayer's position and the taxpayer was allowed to deduct the respective services' expenses.

Comparison with OECD Guidelines
Moldova is currently not an OECD member country and the domestic law does not provide for any reference to the possibility of applying the OECD Transfer Pricing Guidelines.

Moldova

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Mongolia

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Overview

Historically, transfer pricing (TP) was not a substantial issue in Mongolia. The tax legislation contains basic TP rules, but there is limited guidance and enforcement in practice. Nevertheless, tax authorities are starting to pay more attention to transactions between related parties and potential TP adjustments.

TP rules focus on transactions between related parties. There are limited provisions in tax legislation for transfer pricing between unrelated parties; no further guidance exists.

Country	**Mongolia**
OECD member?	No
TP legislation	Yes
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border intercompany transactions?	Yes
Does TP legislation apply to domestic intercompany transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	N/A
When must TP documentation be prepared?	When transaction occurs
Must TP documentation be prepared in the official/local language?	N/A
Are related party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Mongolia

Introduction

Since tax reform in 2006, the tax authorities started using the arm's-length concept to determine fair market value in related-party transactions, as well as in unrelated-party transactions not made at arm's length.

In 2007, by the Ordinance No. 86 of the Minister of Finance, the TP regulation 'Methodology to use benchmark price' was approved. That was followed by the Commissionaire Decree No. 165 of the General Department of Taxation 'List of source information on fair market value for transactions between related parties using unrealistic prices' for determining arm's-length price in related-party transactions.

The CIT return for large taxpayers has been amended and now requires companies to disclose information on related-party transactions.

Legislation and guidance

TP rules in Mongolia are addressed in the General Tax Law (GTL), the Corporate Income Tax (CIT) law, and the Value-added Tax (VAT) law.

TP provisions in tax legislation are applied to the following transactions:

- Transactions between related parties.
- Transactions between unrelated parties not dealing at arm's length.
- Barter transactions.
- Transactions involving netting off receivables and payables.

CIT law (Art. 6.1) provides that a party that holds 20% or more of the common stock, or has the right to receive 20% or more of the dividends and distributions, or has the right to appoint 20% or more of the management of the economic entity or is otherwise able to determine its policies is regarded as a related party of a taxpayer.

However, Art 48.4 of the GTL provides for a broader definition of related entities for TP purposes, which is 'entities authorized to directly and indirectly participate in management, control and property rights of any foreign and Mongolian legal entities'.

Although normally for CIT purposes the tax authorities use the definition of related parties contained in the CIT law, technically, the GTL is applicable, since the GTL is applicable to all taxes.

Transactions between related parties/unrelated parties

GTL gives the right to the tax administration to apply an indirect method in determining tax liability of a taxpayer, if it established that a taxpayer has used unrealistic or not 'arm's-length' prices in their transactions (Art. 48.1).

The law defines two types of indirect methods for determining the value of a transaction for tax purposes. 'Fair value method' is used in determining fair value in related-party transactions by comparing and estimating prices that are applicable in normal market conditions; while 'benchmark price method' is used in establishing fair value in unrelated-party transactions through comparison of operations, income, expenses and other documents of a taxpayer that is in a similar capacity, and in a similar condition to the taxpayer in question.

The TP provision in the CIT law provides that "If related parties have sold or transferred goods, performed work, or rendered services among themselves below or above fair market value, the tax authority shall determine gross taxable income of such goods, work and services based on value involving transactions of similar goods, work and services among non-related parties" (Art. 11.1). This provision is applied only to the related parties defined within this law. Further, CIT law refers to the 'Methodology to use benchmark price' for the purpose of determining taxable income of related parties, based on fair market price.

Value-added tax law
The VAT law does not contain the definition of a 'related party'; therefore, the definition in GTL is used for TP purposes.

TP provisions in VAT law state that if related parties sold goods, performed works and rendered services to each other free of charge, or at lower or higher than market price, then the tax administration will determine the VAT base, based on the fair market value (Art.9.2). Nevertheless, there is no definition of what would constitute a fair market value.

Barter transactions, and transactions involving netting off receivables and payables
In case of exchange of goods, works and services, the taxable value for CIT purposes shall be determined with reference to the value of similar goods, work and services sold among non-related parties.

Closing of debt payments through transfer of goods, performance of work and rendering of services would be treated as sale, and trigger VAT. Taxable value shall be based on the sum of price of transferred goods, work performed or services rendered (VAT law Art. 9.1.5).

Transfer pricing regulation 'Methodology to use benchmark price'
'Methodology to use benchmark price' is the only regulation on determining a fair market value for TP purposes. The methodology has been in force since 2007, and designed for use by tax authorities to calculate a fair market value in transactions between related parties.

The regulation provides only for traditional transactional methods – comparable uncontrolled price (CUP), cost plus (CP), and resale price method (RPM) – for determining fair market value.

Although the regulation does not give guidance on comparability, functional analysis, the general provision of the regulation provides the tax authority with the option (right) to use OECD TP Guidelines in calculating the fair market value.

The regulation states that supervision on 'benchmark price' shall be implemented by the General Department of Taxation, General Customs Authority, and State Professional Inspection Agency (supervisory bodies).

Per the regulation, supervisory bodies are provided with the rights and obligations such as:

- Determining types of goods, work and services that could be conducted at an unrealistic price, collecting information on market prices of particular goods, work and services from the relevant sources, and conducting price trends' observations and surveys on a regular basis.
- Obtaining information on market prices from stakeholders, government and non-government organisations, international organisations and other data sources.
- Overseeing non-benchmark pricing through observation findings and surveys or reviewing compliance with the tax and customs' legislation of Mongolia.

The regulation requires a taxpayer to notify the tax authority about a related-party transaction when submitting a tax return.

The list of prices for the purposes using benchmark price
In 2007, by the Commissionaire Decree No. 165 of the General Department of Taxation, 'List of source information on fair market value for transactions between related parties using unrealistic prices' for determining arm's-length price in related-party transactions was released. The list specifies the resources for determining the fair market value for agricultural products, building materials, lending services and mining products. Resources are maintained by websites of different government agencies, such as the National Statistical Office, Customs office, Bank of Mongolia, etc.

Penalties
At the moment no specific penalty provisions for breach of TP regulations exist. General penalty provisions in Art 74 of GTL will apply for breach of TP rules.

Documentation
There is no requirement to provide TP documentation to the Mongolian tax authorities. Only large taxpayers reporting to the large taxpayers' office are required to disclose in their CIT return, information on shareholders, subsidiaries and affiliates, financial transactions between related parties including details, exchange of goods and liabilities between related parties.

In addition, per TP regulation ('Methodology on benchmark price'), a taxpayer shall compile the following documents each time when selling goods, executing work and rendering services (Art. 4.2):

- Documents describing type of transferred goods, works and services, contractual terms, affiliation status of entities.
- Documents describing price estimation methods, external and internal factors influencing price.
- Documents describing strategy and policy for pricing and profit allocation.

Transfer pricing controversy and dispute resolution

Tax audit

At the moment, Mongolian tax authorities are not conducting specific TP audits. Compliance with TP rules is checked during regular tax audits.

Tax authorities are conducting full scope (covering all types of taxes applicable to taxpayer), or limited scope (covering specific type of taxes, e.g. CIT, excise duty tax, VAT) tax audits on a scheduled or unscheduled (initiated, based on requests, decisions, assignments, complaints, information, application received from state and local organisations, law enforcement organisations, foreign tax authorities in respect to DTT implication, taxpayers or business entities, organisations, individuals and permanent establishment's written request) basis.

The tax system in Mongolia is based on self-assessment, so the burden of proof is on the taxpayer.

Complaint against tax authority's decision

If a taxpayer does not accept the decision of state tax inspectors on tax audit, then it should provide written explanation to the tax authority within ten working days from the receipt of the decision document.

The taxpayer has the right to file complaints related to decisions of state tax inspectors to the Tax Dispute Settlement Council and subsequently to the court within 30 days after receipt of the decision from the tax authority.

Mutual agreement procedure

There is a new regulation, 'Procedure for implementation of Mutual agreement procedure (MAP) of agreements between the Government of Mongolia and the government of contracting state for avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital', outlining the procedure to request assistance from the competent authority (CA) of Mongolia. This regulation was approved by the Ordinance No 260 of the Minister of Finance in November, 2013.

The regulation describes the process whereby taxpayers can apply for CA assistance in cases where a taxpayer is double-taxed due to TP adjustments made by the foreign country's tax administration. The CA should take all possible measures to solve any dispute on application and interpretation of the treaty through negotiation with the CA of the Contracting States.

Comparison with OECD guidelines

TP regulation in Mongolia is very basic, with no details. The regulation describes only traditional transactional methods (CUP, CP and RPM) for determining fair market value with no guidance on comparability, functional analysis.

As mentioned, the TP regulation 'Methodology to use benchmark price' is designed for use by tax authorities to calculate a fair market value in a related-party transaction. The regulation provides the tax authority with the option (right) to use OECD TP Guidelines, which suggests that taxpayers can also use OECD TP Guidelines to prepare their TP documentation.

Mongolia

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Namibia

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Overview

Transfer Pricing (TP) legislation was enacted in 2005. Although TP is currently not actively enforced in Namibia by the revenue authorities, it is important to note that the revenue authorities may apply TP and they can make TP adjustments backwards to 2005.

Country	**Namibia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes, *refer to 'Documentation' section*
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border intercompany transactions?	Yes
Does TP legislation apply to domestic intercompany transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	*Refer to 'Documentation' section*
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Not all, but some (directors' fee and dividends)
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	*Refer to 'Penalties' section*

Namibia

Introduction

TP is currently not actively enforced in Namibia by the revenue authorities. TP legislation was enacted in 2005; therefore, it is important that the Revenue Authorities may apply TP and they can make TP adjustments backwards to 2005.

Legislation and guidance

Namibia introduced TP legislation on 14 May 2005. The legislation was aimed at enforcing the arm's-length principle in cross-border transactions carried out between connected persons. On 5 September 2006, the Directorate of Inland Revenue issued Income Tax Practice Note 2 of 2006 (PN 2/2006), which contains guidance on the application of the TP legislation. The Practice Note is based on guidance set out by the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for multinational enterprises and tax administrations.

The objective of this Practice Note is to provide taxpayers with guidelines regarding the procedures to be followed in the determination of arm's length prices, taking into account the Namibian business environment. It also sets out the Minister of Finance's views on documentation and other practical issues that are relevant in setting and reviewing TP in international agreements.

TP legislation is essentially aimed at ensuring that cross-border transactions between companies operating in a multinational group are fairly priced and that profits are not stripped out of Namibia and taxed in lower tax jurisdictions. The legislation achieves this by giving the Minister of Finance (who essentially delegates to the Directorate of Inland Revenue) the power to adjust any non-market-related prices charged or paid by Namibian entities in cross-border transactions with related parties to arm's length prices and to tax the Namibian entity as if the transactions had been carried out at market-related prices.

Thin capitalisation

Thin capitalisation rules in Section 95A(2) empowers the Minister to disallow the interest expense on the portion of a related party/shareholder loan that they consider to be excessive in relation to the equity of the company.

Where a non-resident (referred to as the 'investor') has granted financial assistance (directly or indirectly) to:

- any 'connected person' (who is a resident) in relation to him or her, or
- any other person (in whom s/he has a 25% or more direct or indirect interest) (other than a natural person) who is a resident (the 'recipient'),

and the Minister is (having regard to the circumstances) of the opinion that the total value of financial assistance given by the investor is excessive in relation to the fixed capital of the Namibian borrower (the recipient), then the cost of the financial assistance (interest and finance charges) on the portion of the financial assistance which is considered excessive, will not be allowed as a tax deduction in the hands of the borrower.

There is no guidance that provides a definition for 'excessive'. Therefore, each case should be considered on the basis of the facts provided. The 3:1 ratio is generally applied by the Bank of Namibia for exchange control purposes, and this guideline is therefore deemed suitable until otherwise determined by the Inland Revenue.

Penalties

TP legislation was enacted in 2005. Although TP is currently not actively enforced in Namibia by the revenue authorities, it is important to note that the revenue authorities may apply TP and they can make TP adjustments backwards to 2005.

Documentation

The Directorate Inland Revenue (DIR) has outlined their requirements for supporting documentation for group TP policies in their Income Tax Practice Note 2/2006 issued on 5 September 2006.

In terms of PN 2/2006, a taxpayer is required to be in possession of TP documentation. If the Minister, as a result of an examination substitutes an alternative arm's- length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Minister or in the courts.

A taxpayer needs to demonstrate that it has developed sound TP documentation in terms of which prices are determined in accordance with the arm's-length principle by documenting the policies and procedures for determining those prices.
However, PN2/2006 acknowledges that preparing documentation is time-consuming and expensive. It will therefore not be expected of taxpayers to go to such lengths that the compliance costs related to the preparation of documentation are disproportionate to the nature, scope and complexity of the international agreements entered into by the taxpayers with connected persons. In these circumstances, taxpayers would be required to submit abridged documentation, identifying the relevant transactions and providing details of the methodologies applied. The taxpayer should use judgement to determine the level of documentation required.

The documentation requirements set out by the PN2/2006 broadly follow Chapter V of the OECD Guidelines. Accordingly, a taxpayer's process of considering whether TP is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. The Minister would expect taxpayers to have created, referred to and retained documentation in accordance with this principle.

PN 2/2006 does not prescribe what kind of documentation should be available, as appropriate documentation depends on each taxpayer's specific facts and circumstances, but recommends some form of functional analysis and information gathering on relevant comparables.

Taxpayers should be able to justify why certain transfer prices are considered to be consistent with the arm's-length principle.

Transfer pricing controversy and dispute resolution

The tax authorities are not auditing TP aggressively in Namibia at this stage. There is also no Namibian case law on TP yet. Since implementation, only one Practice Note has been issued. Therefore, no guidance is available on how controversies and disputes will be resolved.

Comparison with OECD Guidelines

Namibian TP rules follow the OECD Guidelines.

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Netherlands

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Overview

In the Netherlands, transfer pricing (TP) continues to be an area of focus for the Dutch tax authorities. The main changes over the last years are summarised below.

On 14 November 2013 a new decree (No. IFZ2004/184M) of the Dutch Ministry of Finance was published in order to provide guidance on the application of the arm's-length principle. The decree replaces the decrees of 30 March 2001, No. IFZ2001/295 and of 21 August 2004, No. IFZ2004/680M.

The decree provides further guidance on the application of the arm's-length principle and highlights the importance of arm's-length terms and conditions (T&C) and the economic rationale underlying an intercompany arrangement including specific situations that have led to controversies and audit activities over the past decade.

Amendments in comparison with the revoked decrees are:

- A more extensive description is provided on the application of the arm's-length principle in practice; the taxpayer should demonstrate that its transfer prices meet the arm's-length standard.
- Adjustments resulting from changes in laws, regulations, case law and the 2010 Organisation for Economic Co-operation and Development (OECD) Guidelines.
- A more limited explanation on the application of various TP methods as described in the OECD Guidelines
- Specific guidance for intercompany loans, guarantees, captive insurance companies, central purchasing activities and intangibles.
- Further clarification is given on the activities that are considered shareholders' activities and on the term 'mixed' activities: costs of corporate governance can also qualify as mixed activities. Mixed activities are activities performed by a department or another group of persons within the concern, partly qualifying as intragroup services and partly qualifying as shareholders' activities.

In the decree issued on 18 December 2013 (DB/2013/542), the 'information requirement' for financial service companies is set forth and the Dutch Law on International Assistance in Collecting Taxes (in Dutch: *Wet op de international bijstandsverlening bij de heffing van belastingen*) was amended.

This decree and the amendment entered into force on 1 January 2014. According to the information requirements, Dutch financial services companies should disclose in their corporate income tax return whether they fulfil the substance requirements as stated in the decree.

In March 2013, the Supreme Court ruled on a case (Supreme Court, 1 March 2013, No.11/01985) where a company entered a guarantee under a so-called umbrella loan. The Court stated that the reasons for the company to jointly accept liability for the credit arrangement (umbrella loan) with other group companies were motivated by the intra-group relationships. The acts of the company under this umbrella loan were not business-motivated, but governed by the group interest and the company accepted a liability that exceeds the liability that would be borne on a stand-alone basis. Such an umbrella loan will rarely be found among independent enterprises and should therefore be considered as not at arm's length.

Country	**The Netherlands**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border intercompany transactions?	Yes
Does TP legislation apply to domestic intercompany transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Preferably at the time of the transaction. However, it is not mandatory to have documentation at the time of filing the tax return.
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Penalties vary from 0 to 100% of additional tax.

Introduction

Transfer pricing legislation has existed in the Netherlands since 1 January 2002. In addition to providing specific TP rules, the implementation of TP documentation requirements was meant to shift the burden of proof from the Dutch tax authorities to the taxpayer. This legislation is based largely on the OECD Guidelines, with some modifications to reflect Dutch business practices. In the past, TP disputes have usually been dealt with informally and resolved by negotiation between the tax authorities and the taxpayer. Consequently, there is at the moment little relevant case law.

Multinational enterprises (MNEs) are experiencing an increase in the number of TP queries, which will force those companies to focus more on TP.

Legislation and guidance

Statutory rules

Since 1 January 2002, specific TP provisions have been included in Article 8b of the Dutch Corporate Income Tax Act. These articles are largely drafted in accordance with Article 9 of the OECD's Model Tax Convention.

The basic features of the TP legislation are as follows:

- Codification of the arm's-length principle.
- A widening of the scope of the TP legislation through a broader concept of 'control' between affiliated businesses that are directly or indirectly participating in the capital, management or supervision of another company, as long as there is sufficient influence on the prices charged between the companies involved. The level of control and influence is not quantified in the law. This legislation applies to transactions where one party controls the other or both parties are under common control.
- A requirement to maintain data in the administration that demonstrates the arm's-length nature of the transfer prices and how these prices have been derived.
- A strict interpretation of the documentation requirements implies that taxpayers should prepare the relevant documentary evidence when the intragroup transactions take place. Although this is a prudent approach, the tax authorities effectively allow taxpayers four weeks to respond to any request to provide TP documentation, or three months where particularly complex transactions are involved.

Where there is an understatement of the taxable income reported by a Dutch group company because of non-arm's-length related-party transactions, the tax authorities make an upward adjustment to the taxable income of that company. Under certain conditions, the understatement may also be treated as a hidden dividend distribution, attracting the appropriate withholding tax. Any surplus profit reported by a Dutch group company because of non-arm's-length-related party transactions may be treated as an informal capital contribution by the parent company. The Dutch group company can claim a notional deduction for the amount of the informal capital contribution for Dutch corporate income tax (CIT) purposes.

Innovation Box

The Innovation Box is a Dutch corporate tax facility that allows Dutch taxpayers to benefit from a favourable effective tax rate with respect to income derived from qualifying intellectual property (IP). Both resident and non-resident taxpayers can benefit from this facility. The effective tax rate in the Innovation Box is 5%.

The key benefits of the Innovation Box regime are as follows:

- Income from (non-trademark) intangibles will be taxed at an effective CIT rate of 5%.
- Any type of income including royalties, sales proceeds and capital gains, which contain elements as a compensation for qualifying IP can be included in the Innovation Box.
- No limit to attribute income to intangibles under the Innovation Box.
- Innovation losses are deductible against the normal CIT rate.

- The scope is broad; it is not limited to only patented intangibles. It provides opportunities for companies involved in technological innovation, which is not always patented or patentable. This includes opportunities for production companies with non-patented process technology and software companies.
- To a certain extent the development of intangibles can take place outside the Netherlands.
- The Dutch tax authorities are cooperative in concluding agreements on defining allocation keys determining that part of the taxable income to which the Innovation Box applies.

For IP to qualify for the Innovation Box, it needs to meet the following cumulative conditions:

- IP developing test:
  - The Dutch entity should have developed the IP, either in-house or partially via contract R&D arrangements, in respect of which:
    a. a patent is granted to the Dutch entity, or
    b. an R&D declaration is issued for the in-house development activity.
- IP economic ownership test:
  - The developed IP should be actively managed and maintained by the Dutch entity.
  - Any redevelopment of the IP should be actively managed and controlled by the Dutch entity.
- New IP:
  - The Innovation Box is available for newly developed IP from after the introduction of the Innovation Box regime.
  - For existing or acquired IP, which is subject to continual improvements and redevelopment, the Innovation Box can be gradually applied via a phase-in mechanism.

Other regulations

Other regulations have been issued to cover certain specific circumstances. Those that concern TP issues are detailed below.

Decrees and resolutions

The decrees and resolutions issued by the Ministry of Finance give guidance on the interpretation and application of Dutch tax law in certain specific situations. They are intended to ensure a consistent application of the tax laws and, consequently, the tax authorities are bound by them. A taxpayer, however, has the right to appeal to the courts on any provision in the decrees or resolutions.

Details of the relevant decrees are set out below:

Transfer pricing decree (No. IFZ2013/184M)

On 14 November 2013 a new decree (No. IFZ2014/184M) of the Dutch Ministry of Finance was published in order to provide guidance on the application of the arm's-length principle. The decree replaces the decrees of 30 March 2001, No. IFZ2001/295 and of 21 August 2004, No. IFZ2004/680M.

The decree provides further guidance on the application of the arm's-length principle and highlights the importance of arm's-length T&C and the economic rationale underlying an intercompany arrangement including specific situations that have led to controversies and audit activities over the past decade.

Amendments in comparison with the revoked decrees are:

- A more extensive description is provided on the application of the arm's-length principle in practice; the taxpayer should demonstrate that its transfer prices meet the arm's-length standard.
- Adjustments resulting from changes in laws, regulations, case law and the 2010 OECD Guidelines.
- A more limited explanation on the application of various TP methods as described in the OECD Guidelines.
- Specific guidance for inter-company loans, guarantees, captive insurance companies, central purchasing activities and intangibles.
- Further clarification is given on the activities that are considered shareholders' activities and on the term 'mixed' activities: costs of corporate governance can also qualify as mixed activities. Mixed activities are activities performed by a department or another group of persons within the concern, partly qualifying as intragroup services and partly qualifying as shareholders activities.

Below we have set out the main (new) subjects included in the TP decree.

Non-arm's-length shift in profits
A key element of the new decree is that it specifically addresses the fact that there may be situations in which there is a non-arm's-length shift of profits. In these situations, it is considered appropriate to challenge such a shift of profits by ignoring or replacing the legal arrangement between the parties involved. For a number of situations, the decree describes the possible challenges of a shift in profits.

Intercompany services/head-office expenses
Some clarification is given on the activities that are considered shareholder activities. In addition, the decree provides guidance on the determination of an arm's-length fee for services. It allows a fee based on cost for support services that meet certain criteria, thereby providing a practical approach for common, low value-added services.

Low value-added services
The decree allows a fee based on actual cost (only) for support services that meet certain criteria, thereby providing a practical approach for common, low value-added services.

Contract R&D
In the decree the tax authorities explicitly referred to performing contract R&D from a Dutch tax perspective. In addition, a guideline now defines the manner in which these activities should be remunerated. The decree indicates that if ultimate decision-making related to the R&D, the costs and the risks of these activities and the economic ownership of the developed assets lie with the principal, then the cost plus (CP) method is an appropriate method for remunerating the contract R&D activities.

Cost contribution arrangements
To end further discussions as to whether the cost contribution paragraph in the March 2001 decree was completely in accordance with the arm's-length principle, this paragraph has been revoked in the 2013 decree, and it is explicitly stated in the amendments that the OECD Guidelines apply.

Intangible assets
According to the decree, the arm's-length criteria will not be met in the situation an intangible asset is transferred to a group company, while the group company is not adding value to the respective asset because it does not have the required functionality and is therefore not able to control the risks with regard to the intangible assets. The legal owner of the intangible asset, which does not fulfil the relevant functions with respect to the intangible asset, is entitled to a limited return.

Central purchasing function
According to the Ministry of Finance, if a group realises higher discounts by centralising its purchasing function, due to the increased purchase volume, this benefit in principle is not attributable to the central purchasing entity. Only if and insofar extra discounts are realised due to specific knowledge and skills that are available at the central purchasing entity, it is in line with the arm's-length principle to attribute part of the benefits to the central purchasing entity.

Internal guarantees
There are cases in which internal credit guarantees are provided because of shareholder relations. A guarantee is not considered a service for which a fee is due when the borrower is not able to attract funds on a stand-alone basis without the presence of a guarantee. In that case, the third-party loan is considered to be an inter-company loan (and a guarantee fee should not be charged). If the guarantee is invoked by the lender, the corresponding payment is considered to be provided because of shareholder relations (i.e. the loss on the invoked guarantee is not tax deductible).

Compared to the Supreme Court ruling on credit guarantees of 1 March 2013 (No. 11/01985), the decree is more detailed and its approach towards guarantees is more economic. In order to establish whether a guarantee fee is due for an explicit guarantee, one has to consider to what extent the more favourable T&C can be attributed to the presence of an implicit parent guarantee. The effect and extent of an implicit parent guarantee should be considered when the group can be expected to fulfil the liabilities of the borrower, taking into account its strategic importance, even without the presence of an explicit credit guarantee.

Captive insurance
Within a group, certain companies may formally engage as captive insurers. However, in some cases the captive insurer does not perform the typical activities of a third party (re-) insurer, such as product development, marketing & sales, acceptance of insurance contracts, asset/liability management and the development of an independent policy for reinsurance. Besides, there is no active diversification of the risks associated with the insurance activities (i.e. passive diversification within the group).

According to the decree, in these cases, the captive insurer may be considered to perform merely a coordinating function for which it requires a limited return only. As a result, the transaction is ignored and the insurance fees are reallocated.

Finance transactions
To assess whether a finance transaction is at arm's-length, the T&C (including price) of the transaction should be comparable with T&C agreed between third parties. If not comparable, an adjustment may be required. If possible, this adjustment should be made with a price (interest) adjustment. Otherwise, other T&C should be adjusted. The latter is mostly the case in the situation of non-arm's-length risk allocation (e.g. because of a lack of securities).

If an adjustment does not result in an arm's-length transaction, in extreme cases the intercompany loan is (partly) reclassified/ignored. As a result, (part) of the loan is treated as equity on which no interest deduction is possible. Besides, a write-off on the loan is not deductible. For the remaining (arm's-length) part of the loan, an arm's-length interest rate can be determined.

Decrees on finance companies (No. IFZ2004/126M, No. IFZ2004/127M and No. DB/2013/542)
The regime for Dutch finance companies is applicable to back-to-back intercompany loans and intercompany licensing transactions.

Under this regime, a Dutch finance or licence company must meet the following requirements:

- The company must incur economic risk.
- The company must have sufficient operational substance.

On 11 August 2004, the Ministry of Finance published two decrees for Dutch companies involved in inter-company financing activities. The first decree, issued on 11 August 2004 (No. IFZ2004/126M), focuses on companies involved in inter-company finance activities. The second decree, also issued on 11 August 2004 (No. IFZ2004/127M), contains questions and answers on the decree's application.

The importance of the regime lies in what happens if the requirements are not met. In such a case, interest and/or royalties paid and received are not included in the Dutch tax base. In addition, the Dutch tax authorities may spontaneously exchange information with local tax authorities of the countries to which the loan/licence is granted. This will likely result in an increase of withholding tax on these payments, which can subsequently not be offset in the Netherlands, as the interest and royalty are not included in the Dutch tax base.

In addition to the specific requirements for Dutch finance companies, the decrees also set out how the compensation for back-to-back intercompany loans and intercompany licensing transactions need to be established and documented. This needs to be done on a case-by-case basis and the compensation typically needs to consist of a handling fee component and a risk premium.

In the decree issued on 18 December 2013 (No. DB/2013/542), the 'information requirement' for financial service companies is set forth and the Dutch Law on International Assistance in Collecting Taxes (in Dutch: *Wet op de international bijstandsverlening bij de heffing van belastingen*) was amended.

This decree and the amendment entered into force on 1 January 2014. According to the information requirements, Dutch financial services companies should disclose in their CIT return whether they fulfil the substance requirements as stated in the decree. The decree defines a Dutch financial service company as a Dutch resident corporate taxpayer, whose activities mainly consist of receiving and paying interest, royalties, rent or lease. In case a financial services company does not or no longer meets all substance requirements, it should provide additional information:

- A declaration of the company, stating which substance requirements are not met.
- All data and information necessary for assessing whether substance requirements are met.
- An outline of the received interest, royalties, rent and lease payments in respect to which the financial services company received – or could apply for – tax relief on the basis of an arrangement for the avoidance of double taxation.
- The name and address details of the companies from which the interest, royalties, rent and lease payments, referred to in the above point, have been received.

If a Dutch financial services company does not meet all substance requirements, the Dutch tax authorities will spontaneously exchange relevant information to the foreign state(s) in which the financial services company received tax relief on the basis of an arrangement for the avoidance of double taxation.

Not or not timely complying with the information requirement is treated as a violation, and can result in an administrative penalty of up to EUR 19,500.

It is also possible to obtain a unilateral advance pricing agreement (APA) in the Netherlands in which the Dutch tax authorities confirm (i) that the requirements are met, and (ii) that the remuneration applied (a spread determined on a case-by-case basis) is at arm's length.

Advance pricing agreement (APA) decree (No. DGB 2014/3098)
On 3 June 2014, the Ministry of Finance published a decree titled 'Procedure for dealing with requests for advance pricing agreements'. The decree replaced the APA decree of 11 August 2004 (No. IFZ2004/124M). This decree provides guidance on how the OECD Guidelines on APAs are applied in the Dutch practice and explains the APA procedure.

Details about the procedures to be followed and the information given in an APA request are provided in the TP controversy and dispute resolution section, below.

Decree on mutual agreement procedures (MAP) and European Union (EU) Arbitration Convention (No. IFZ2008/248M)
The decree of 29 September 2008 seeks to give guidance for taxpayers and improve the efficiency of the process for resolving disputes, and it relates both to MAPs initiated under double tax treaties (DTTs) and the arbitration convention for TP disputes within the EU.

Decree on attribution of profits to permanent establishments (PEs) (No. IFZ2010/457M)
On 15 January 2011, the Dutch State Secretary of Finance issued a decree on how the Dutch tax authorities apply the OECD publications on the attribution of profits to PEs. The Dutch approach for the attribution of profits to a PE generally follows the OECD recommendations: the PE should be seen as a legally distinct and separate enterprise. In the first step of this approach, assets and risks are attributed to the head office or the PE, based on a functional analysis. Subsequently, free capital and loans are allocated to the PE. Finally, interest is determined for the loans that have been attributed to the PE.

With regard to capital allocation, the State Secretary expresses a strong preference for a capital allocation approach (based on the company's capital position). When it comes to attributing interest to the loans allocated to the PE, the State Secretary expresses a strong preference for the 'fungibility approach' (pro rata allocation of interest costs).

Under Article 7 of the OECD Model Tax Convention, executive and administrative expenses should be allocated to the PE with an arm's-length mark-up. The State Secretary has indicated that for the applicability of treaties containing the old Article 7, both methods of attributing costs to the PE (i.e. with or without an arm's-length mark-up) are considered to be acceptable. In addition, royalty charges between the head office and a PE can be acceptable if the development cost has been attributed to one part of the enterprise.

Advance tax rulings (ATRs)
Effective from 1 April 2001, the former Dutch ruling practice was converted into an 'APA/ATR' practice. Reference is made to the 2014 decree on APAs and the 2004 and 2013 decrees on finance companies.

ATRs typically deal with issues like the applicability of the participation exemption and the existence of a PE.

Legal cases
There are relatively few court cases on TP issues since most disputes are solved through compromise. One reason is the ability to obtain an APA from the Dutch tax authorities on the arm's-length nature of certain TP arrangements. Currently, the Dutch tax authorities are a strong advocate of bilateral or even multilateral APAs. Another factor may be that the burden of proof in TP disputes historically lies with the tax authorities, and the confidence of the tax authorities in this regard may have been a relevant factor.

This is illustrated by a Supreme Court decision of June 2002, which involved a Japanese parent with a distribution subsidiary in the Netherlands (Supreme Court, 28 June 2002, No. 36 446). The Dutch subsidiary sold a certain product at a loss for a lengthy period of time while the remaining product range was profitable. The transfer prices for all products were set by the parent company without clear evidence of negotiations. The Dutch tax authorities challenged the arm's-length nature of the transfer price for the loss-making product, arguing that a third party would not have continued selling this product under these conditions. The High Court argued that the tax inspector wrongfully looked at only the loss-making product. Also, the Court held that the tax inspector had the burden of proof and failed to demonstrate that third-party distributors would not have agreed to the pricing arrangements for the transactions under review. The Supreme Court upheld the decision of the High Court and decided in favour of the taxpayer.

From this Supreme Court decision, one may conclude that the burden of proof rests with the tax authorities, even if a taxpayer reports a profit margin that is relatively low and differs from the industry average. The Supreme Court also ruled that for the arm's-length test, certain transactions can be aggregated and a particular product may be unprofitable if the overall result for the company represents a fair return on the capital employed and the business risks incurred.

On 13 September 2002, the State Secretary of Finance issued a decree (No. IFZ2002/830M) on the consequences of this Supreme Court decision. In the decree, it was concluded that the Supreme Court decision results in a heavy burden of proof for the tax authorities for the years before 1 January 2002.

In October 2005, the Supreme Court ruled on a case (Supreme Court, 14 October 2005, No. 41 050) that dealt with the issues of dual residency and the existence of a PE. An MNE with a head office located in the Netherlands operated its group financing function through a company located and incorporated in Belgium. The Supreme Court ruled that since a significant part of its core activities were on a day-to-day basis performed by the Belgian employees, the company should not have had dual residency and was therefore not subject to Dutch corporate income tax. Moreover, the involvement of the Dutch head office had not exceeded a normal level of involvement within a group, and as a result it could not be concluded that the Belgian group company had a PE in the Netherlands.

In the Netherlands, the tax authorities increasingly not only focus on the arm's-length nature of the conditions of a transaction, but also on the arm's-length nature of the transaction itself. An example in relation to the aforementioned is the case ruled by the Supreme Court in May 2008.

In May 2008, the Supreme Court ruled on a case (Supreme Court, 9 May 2008, No.43 849) where a loan had been issued by a company to its parent company and where subsequently the lender was faced with a default on that loan. The court ruled that if and to the extent a supply of funds occurs on terms and under conditions such that a third party would not have assumed the debtors risk, it must be concluded that the supplier of the funds had accepted the debtors risk with the intent to serve the interests of its shareholder.

In March 2013, the Supreme Court ruled on a case (Supreme Court, 1 March 2013, No.11/01985) where a company entered a guarantee under a so-called umbrella loan. The court stated that the reasons for the company to jointly accept liability for the credit arrangement (umbrella loan) with other group companies were motivated by the intra-group relationships. The acts of the company under this umbrella loan were not business-motivated, but governed by the group interest and the company accepted a liability that exceeds the liability that would be borne on a stand-alone basis. Such an umbrella loan will rarely be found among independent enterprises and should therefore be considered as not at arm's length.

Burden of proof
Since 2002, taxpayers have a legal obligation to maintain certain TP documentation. To the extent that this requirement is not met, the burden of proof is ultimately transferred to the taxpayer. In general, there are no statutory provisions to indicate how the burden of proof is divided between the taxpayer and the tax authorities. The allocation of the burden of proof between the parties is at the discretion of the court. However, in practice and as a result of Dutch case law, if the company's revenue is adjusted upwards because of TP issues, the burden of proof usually lies with the tax authorities. On the other hand, the burden lies with the taxpayer to prove the deductibility of expenses.

In TP cases, the burden of proof transfers to the taxpayer if the pricing arrangements are unusual (e.g. if comparable uncontrolled prices (CUP) are available but not used, or goods or services are provided at cost or below cost). The burden of proof is also transferred to the taxpayer and will be more onerous if the taxpayer refuses to give information requested by the tax authorities where there is a legal obligation to do so, or if the requisite tax return is not filed. Finally, the court sometimes allocates the burden of proof to the party best able to provide the evidence.

Anticipated developments in law and practice
With the existence of specific TP legislation in the Netherlands and considering the increased awareness of the Dutch tax authorities with respect to TP matters and the EU and OECD developments, the most likely development is that, in practice, intragroup transactions will be reviewed even more closely and challenged even more frequently than is the case presently. This is also a result of the active approach to TP by the EU and OECD and the authorities of the most important Dutch trade partners, like Germany and the US. These developments will force MNEs to review their TP policies and carefully document them in order to defend their prices against future challenge.

Liaison with customs authorities
The exchange of information between the CIT authorities and the customs' authorities takes place as part of the daily routine of the Dutch tax authorities. The special customs' valuation team based in Rotterdam often directly cooperates with the CIT authorities throughout the process of an investigation for customs' purposes. Also, combined customs and CIT teams exist within other major offices of the Dutch tax authorities. In addition, the customs' authorities have implemented a database containing pricing structures and price levels for different industries.

- In case of a customs' valuation audit, the following information may be requested by the customs' authorities:
- General information on the company.
- Available information on transfer prices (e.g. TP studies, TP policies).
- Annual accounts.
- Legal structure including contracts and agreements in place.
- Specific information on the goods flow, invoicing structure (including retrospective price adjustments), special arrangements (e.g. tools, machines, goods or materials provided to the manufacturer – so-called 'assists'), royalties, warranty and marketing.
- Reports of foreign customs' audits.

A copy of the customs' valuation report is usually forwarded to the CIT authorities. In principle, any TP adjustments made for CIT purposes should be reported to the customs' authorities, unless the adjustments relate to items that are not dutiable for customs' purposes. A request for a refund of customs' duties, in the event that the import prices are adjusted downwards, should be submitted within three years of the date of actual importation and be supported with documentation explaining that the adjustment was already an option at the moment of importation. In the event that the import prices are adjusted upwards, an adjustment should be reported to the customs' authorities. The customs' authorities then issue an assessment for the underpaid customs' duties.

The customs' authorities can impose an additional assessment within three years of the date of actual importation. In cases where the customs' authorities feel that the underpayment of customs' duties was a deliberate action to avoid payment of customs' duties, the period for assessing the duties may be extended to five years.

The customs' authorities have raised more queries on the intragroup purchase prices in situations where the group company purchasing the goods has little or no real economic risk. This may apply to distribution centres with a cost plus remuneration, but which are still part of a buy/sell structure, or to low-risk distribution companies. In these situations, the customs' authorities may attempt to argue that the intragroup purchase price, although in line with the TP policy, does not qualify as transaction value according to the customs' valuation regulations. This is because the customs' authorities, due to lack of economic risk by the purchasing company, argue that the economic ownership has not been transferred (as required from a transaction value perspective). Furthermore, the Dutch customs' authorities look into the remuneration of buying agents. Only limited activities and thereby a reduced remuneration will qualify as buying commission that can be excluded from the customs' value. On this they often liaise with corporate tax authorities for verifying whether the information on the activities performed and the remuneration of these are matching. In addition, the customs' authorities will verify whether there are additional payments with respect to the imported products (e.g. for royalties) and if so whether these should be included in the customs' value and thereby become subject to customs' duties. Therefore, it is advisable to also consider customs' valuation issues when implementing TP or CIT arrangements (this is relevant only when the imported products are subject to an actual duty levy). Furthermore, if the customs' authorities do not accept a transaction value, some questions need to be dealt with from a value-added tax perspective (i.e. who may deduct the value-added tax at import and what is the value-added tax status of the service provider in the case of a CP arrangement).

Penalties

The Dutch legislation does not provide for specific TP penalties. Nevertheless, the existing penalty rules are applicable on any additional tax resulting from TP adjustments. The penalties vary from 25% to 100% of the additional tax, depending on the deliberate intent to avoid taxation or the gross negligence of the taxpayer leading to underpayment of taxes. Penalties are not deductible for CIT purposes.

Note that TP adjustments do not often result in penalties, because the taxpayer's position is usually more or less defensible and therefore is not strictly considered as tax avoidance. However, an additional tax assessment results in interest charges.

Documentation

Transfer pricing legislation has existed in the Netherlands since 1 January 2002. Dutch TP legislation does not give a clear indication as to exactly what the minimum requirements are in terms of documentation. However, in the explanatory memorandum on the legislation, reference is made to the OECD Guidelines in this respect. The decree of November 2013 also provides some guidance on the documentation that should be maintained and the option for taxpayer to apply the 'EU Transfer Pricing Documentation' in accordance with the EU Code of Conduct on TP documentation. It is understood that the documentation should include the following:

- A summary of the relevant intragroup transactions.
- A functional analysis.
- An industry analysis.
- A summary of the TP methods and margins used including evidence that the methods have resulted in an arm's-length outcome.
- Details on the company's strategies including critical assumptions.
- Intragroup arrangements including the trading conditions.

Transfer pricing controversy and dispute resolution

Tax audit procedures

Selection of companies for audit

There are no clear criteria as to how companies are selected for a TP investigation, but a company bears an increased risk of such an investigation if one of the following situations occurs:

- The company has suffered losses for a number of years.
- The company is involved in transactions with related parties in tax havens.
- The company shows fluctuating results from year to year.
- The company closes.
- The company's activities are reorganised.
- The results of the company are lower than the average for the industry.
- The company pays substantial royalties or management fees.

The Dutch tax authorities conduct centrally coordinated TP investigations for certain industries, such as the pharmaceutical and automobile industries.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

In accordance with the General Tax Act, a taxpayer can be compelled by the tax authorities to give access to all books and other documentation relevant to the determination of the facts of the company's tax position. If a taxpayer does not provide the requested information to the tax authorities, the burden of proof may be transferred to the taxpayer. In addition, failure to comply can be considered a criminal offence, which could ultimately result in penalties or even imprisonment.

With respect to requests for information about foreign group companies, which can affect the Dutch company's tax position, the situations set out below can be distinguished.

A Dutch company with a majority shareholding in a foreign company
In this situation, the Dutch tax authorities can, at least in their own view, require the Dutch company to provide information on, and give access to, the books and records of the foreign subsidiary. If the requested information is not provided, the burden of proof may transfer to the taxpayer.

A Dutch company with a foreign parent company or fellow subsidiary
The Dutch tax authorities can request a Dutch company to provide information on its foreign parent company or fellow subsidiary. However, a taxpayer is not obligated to provide this information if the parent company or fellow subsidiary is resident in either the EU or a country with which the Netherlands has a tax treaty that includes a provision for the exchange of information. In this case, the information should be requested directly from the foreign tax authorities. If this process fails, no tax treaty exists or the treaty does not include an exchange of information article, the Dutch tax authorities can request access to the books and records of the foreign parent company or fellow subsidiary. If the requested information is not provided, the burden of proof may transfer to the taxpayer.

The audit procedure
Transfer pricing matters usually are an integral part of a general state audit. A state audit comprises an onsite examination of the company's books, which usually cover a number of years, taking into account the five-year period within which the tax authorities may statutorily reassess taxes. This period is extended with the extension period granted for filing the tax return. Historically, the tax authorities concentrated largely on the TP of goods, the treatment of intangible assets and the allocation of head-office costs by Dutch MNEs. These may be examined through separate TP state audits, as the Dutch tax authorities are more active in this area.

The conduct of the taxpayer during the investigation, particularly with respect to requests for information from the tax authorities, could have an effect on the outcome of the dispute and the size of the adjustment. Transfer pricing disputes between the Dutch tax authorities and the taxpayer are usually solved through negotiation rather than litigation. Note, however, that an additional assessment is the most likely outcome, since most disputes are solved through compromise.

Furthermore, the Dutch tax authorities tend to enhance the relationship with the taxpayer through so-called horizontal monitoring, which is to pursue an effective and efficient method of working based on mutual trust, understanding and transparency. As a result, the tax audits shift from tax audits performed by the Dutch tax authorities afterwards (reactive) to having upfront assurance from the Dutch tax authorities (proactive) whereby more and more is focused on internal risk and control processes of the company (Tax Control Framework).

Revised assessments and the appeals procedure
The taxpayer may appeal against the revised assessment and should do so within six weeks of the date when the additional assessment was raised. The tax authorities should make a formal decision on the appeal within six weeks after this period. If the tax authorities are not able to give a decision within this term, they may extend the period for another six weeks at most. The tax authorities cannot just reject the appeal without first providing an explanation for the decision.

If the tax authorities reject the initial appeal, the taxpayer can file an appeal with the District Court against the decision. This appeal must be filed within six weeks of the tax authorities' formal decision. To speed up the decision process, if there is mutual consent between the taxpayer and the tax inspector, the appeal to the tax inspector can be bypassed by sending the appeal directly to the District Court. This is then treated as an appeal with the District Court.

There is no ultimate time limit within which the District Court must make its decision. Following its decision, the taxpayer or the tax authorities can file an appeal with the Dutch High Court within six weeks. Once the High Court has made a decision, the taxpayer or the tax authorities may appeal the decision on points of law to the Supreme Court. Such an appeal must also be filed within six weeks of the High Court's decision. The Supreme Court is the final court; its decision is binding, and no further appeal is permitted. There is no ultimate time limit within which the High Court and the Supreme Court must make their decision. To speed up the decision process, and with mutual consent between the taxpayer and the tax inspector, the appeal to the High Court can be bypassed by sending the appeal directly to the Supreme Court. This short cut should only be advised in case both parties agree on the relevant facts. Generally, a taxpayer will want to avoid litigation since it can be a very time-consuming and costly exercise.

Resources available to the tax authorities

Transfer pricing enquiries are conducted by the local tax inspector and the tax auditor, usually in consultation with specialised accountants from the TP Co-ordination Group. This group is dedicated to TP and includes people from the Ministry of Finance and the tax authorities. Its main task is to prepare policies for those instances of incorrect application of the arm's-length principle regulation. In addition, the Group should be consulted by the tax authorities and the Ministry of Finance on any TP issue (including allocation of profit between head office and PE), and it should guarantee a consistency in dealing with TP matters. TP cases dealt with by the local tax inspector should also be reported to this Group. This particularly applies to the following scenarios:

- Cross-border transactions with related entities established in tax havens.
- Proposed TP audits.
- Cross-border transactions that are, or will be, assessed as part of an industry examination.
- A request by a taxpayer for a corresponding adjustment in the area of TP as a result of a (proposed) adjustment at a related entity in another state.
- If it is likely that a mutual agreement or an arbitration procedure will be started.
- A cross-border transfer of intangible assets within a group.
- A request for advance certainty on the extent of the documentation requirements of Article 8b of the Corporate Income Tax Act.

The Group reviews (interim) reports, provides binding advice to the local tax inspector and also operates as a help desk for staff members of the tax authorities. This binding advice does not relate to APA requests because the local tax inspectors should involve the centralised APA/ATR team for these.

Use and availability of comparable information

Use of information

As indicated above, the principles in the OECD Guidelines have been accepted by the Netherlands and are generally applied. Since the OECD Guidelines recommend the use of comparable information, a comparables study is an appropriate means to justify a TP policy. Furthermore, the reference to comparables in the explanatory notes on the TP legislation makes it evident that comparables information is a crucial element in defending transfer prices in the Netherlands.

The tax authorities have access to their own comparables data, and they also use commercially available databases (see below). According to the TP legislation and their explanatory notes, it is, strictly speaking, not mandatory for a taxpayer to perform a comparables study (i.e. benchmarking) to support its TP policy. On the other hand, in the absence of a comparables study, it is likely that the Dutch tax authorities will perform such a study themselves. It is therefore advisable for a taxpayer to perform a comparables study to support the arm's-length nature of its pricing arrangements. In case of an APA, a comparables study is required as part of the information to be provided to the tax authorities.

Availability

Dutch companies are required to file their statutory financial statements in full or abbreviated form (depending on the size of the company) with the local chamber of commerce. This information is compiled on a publicly accessible database and may be used by other companies in similar situations to justify or defend a pricing policy.

The tax authorities can also obtain and use all information that is publicly available including external databases, to support its position. In addition, the tax authorities may use information (e.g. gross margins or net operating profit margins) obtained from CIT returns and state audits. However, such information is rarely used as evidence before the courts because the tax authorities might be compelled to disclose the underlying financial information and this might put the tax authorities in breach of their confidentiality obligations.

Risk transactions or industries

No transactions or industries are excluded from the scope of the TP legislation. Historically, the Dutch tax authorities have primarily focused on intragroup charges like royalties, management fees, commissions and interest payments, as well as intragroup transactions with low-tax countries and intragroup transactions involving intangible assets.

Since the introduction of the TP decrees and the legislation, there is a tendency for more queries to be raised concerning the transfer prices and margins of goods, as well as the allocation of head-office costs and related service charges by Dutch MNEs. In addition, the Dutch tax authorities are increasingly becoming sophisticated in the area of intercompany financial transactions including the arm's-length nature of the interest rates applied on group loans, cash pooling and credit guarantees.

Limitation of double taxation and competent authority proceedings
Most tax treaties for the avoidance of double taxation concluded by the Netherlands include provisions for a MAP. Moreover, the Netherlands has concluded a treaty containing an arbitration clause with approximately 23 countries including treaties with Japan, Switzerland and the United Kingdom. In the Netherlands, a request to initiate the MAP should be filed with the Dutch Ministry of Finance, generally within three years of the tax assessment with the adjustment that results in double taxation. The Dutch Ministry of Finance has issued a decree on the application of MAP procedure or EU arbitration procedure to provide guidance for taxpayers and improve the efficiency of the process for resolving disputes. No information is available on the number of requests made as the Ministry of Finance has not disclosed this information. The use of the competent authority procedure had increased significantly over the last years. Most cases are solved within a period of two to three years. Additionally, it is understood that it is part of the Dutch treaty policy to include an arbitration clause in future tax treaties.

Joint investigations
In principle, the Netherlands could join with another country to undertake a joint investigation of an MNE for TP purposes. In the few circumstances when a joint investigation has taken place, it was usually initiated by the foreign tax authorities.

Advance pricing agreements
There are formal procedures in the Netherlands for setting pricing policies in advance through a unilateral or bilateral APA. The authority for the APA procedures lies in the APA decree published by the Ministry of Finance on 3 June 2014 which is an update of the decree of 11 August 2004 (No. IFZ2004/124M). APAs may include TP methodologies covering different types of related-party transactions or specific transactions including transfers of tangible or intangible property, financing and licensing activities and the provision of services. APAs may cover all the taxpayer's TP issues or may be limited to one or more specific issues.

Since the publication of the 2004 decree, the number of APAs concluded by the Dutch tax authorities has increased significantly. An APA request requires a certain amount of detail to be disclosed to the tax authorities. However, this is not materially different from the documentation that the taxpayer must maintain under the TP documentation requirements.

The information to be provided to the tax authorities by the taxpayer as part of an APA request generally includes, among other things, the following:

- Details on transactions, products and agreements relating to the proposal.
- Details on the entities and PEs involved.
- The relevant jurisdictions.
- Details on the worldwide group structure, history, financial data, products, functions, risks and (in) tangible assets involved.
- A description of the proposed TP method including a comparables analysis.
- Details on the critical assumptions applied in the proposal and the implications of changes therein. This would allow certain flexibility in the actual application of the APA, provided that the critical elements (e.g. market share or value chain) fluctuate within a certain predetermined range.
- The accounting years involved.
- General information on the market conditions (i.e. industry analysis).

The APA request needs to be filed with the tax inspector or directly with the APA/ATR team of the Dutch tax authorities (particularly in cases where the request concerns activities to be established in the Netherlands). In all cases, the inspector is obliged to present the request to the APA/ATR team of the Dutch tax authorities for binding advice (in cases of new policy after consultation of the Transfer Pricing Co-ordination Group). In the case of a bilateral APA request, the Dutch Ministry of Finance initiates the bilateral agreement procedure with the other country involved. In principle, an APA is applicable for a period of four to five years unless longer term contracts are involved. Under certain conditions an APA can be applied retroactively, for example, as part of a conflict resolution during a state audit. The Dutch tax authorities are eager to make the APA regime work and, as a result, according to the Dutch State Secretary of Finance, the Dutch tax authorities maintain a professional, flexible and cooperative international reputation in this area. The APA decree of 3 June 2014 (No. DGB 2014/3098) entails various measures. These measures relate to the possibility of a pre-filing meeting, the possibility of potential retrospective effect of the APA and the possibility of assistance by the tax authorities in identifying comparables data for small businesses (i.e. companies with a balance sheet total of less than EUR 5 million and with an average number of employees of less than 50).

The pre-filing meeting creates the potential to discuss the APA request with the APA team before it is actually filed. The benefit to the taxpayer is a clarification of the information that is likely to be required and specific elements likely to be pertinent to the formal APA request.

In cooperation with the APA team, a joint case management plan (i.e. a work plan) can be prepared describing the process and timing between the filing and the completion of an APA request. The intention of this case management plan is to reduce the uncertainty for the taxpayer with respect to the handling process of the application. The case management plan should provide a realistic time frame for the completion of the request as agreed by both parties.

To decrease the administrative burden for smaller companies, the tax authorities, to the extent possible, give comparable financial information of independent enterprises. This assistance should make it easier for relatively small companies to file an APA request, as many small companies are reluctant to enter the APA process due to the administrative burden and related costs. The taxpayer still must provide the necessary information on the organisation and functional analysis of the company, as well as the rationale for the proposed TP method and mechanisms, for example.

Comparison with OECD Guidelines

The Netherlands is a member of the OECD, and according to the TP Decree of 14 November 2013, the OECD Guidelines are directly applicable in the Netherlands. Also, the explanatory memorandum to the October 2001 proposals on the TP legislation, effective from January 2002, reconfirms the adoption of the OECD Guidelines by the Dutch tax authorities.

72.

New Zealand

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Overview

The New Zealand Inland Revenue (Inland Revenue) has again identified transfer pricing (TP) as a key focus area for review. While nothing has changed in New Zealand's domestic TP rules (and double tax agreements [DTA]), the political pressure to address global concerns about base erosion and profit shifting (BEPS) is shared by the Inland Revenue. This has led to increased scrutiny of TP arrangements – particularly in relation to significant business restructurings, and transactions involving intangibles and financing arrangements.

Country	**New Zealand**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
No but IR does follow OECD Guidelines.	
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	No statutory requirement to have TP documentation in place. Inland Revenue almost always request documentation during a tax audit and usually as part of a tax return risk review process.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No

New Zealand

Country	New Zealand
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	The penalty will be a portion of the tax shortfall. Determination of the portion focuses on culpability.

Introduction

New Zealand enacted its TP legislation on 12 December 1995, with effect from the income year ending 31 March 1997. The Inland Revenue issued TP guidelines in final form in October 2000.

The Inland Revenue does not intend to update these guidelines in the future. Instead, the Inland Revenue now relies on the latest 2010 Organisation for Economic Co-operation and Development (OECD) Guidelines, which are consistent with New Zealand's TP legislation and double taxation treaties.

Over recent years, the Inland Revenue has lifted its game and sophistication in terms of TP enforcement. In this regard, the Inland Revenue has instigated a number of specific TP review programmes. In particular, it maintains a special focus and conducts comprehensive annual reviews on the top foreign-owned multinationals (with revenue in excess of NZD 300 million).

The Inland Revenue supports the advance pricing agreement (APA) programme and a cooperative approach to addressing TP compliance. The Inland Revenue has agreed at least 123 APAs since the programme was started.

Legislation and guidance

The current TP legislation is contained in sections GB 2 and GC 6 to GC 14 of the Income Tax Act 2007 (tax act). (The relevant sections in the Income Tax Act 2004 are GD 13, FB 2 and GC 1. On 1 April 2008, the Income Tax Act 2007 superseded the Income Tax Act 2004. The purpose and intention of the provisions remain the same. The Income Tax Act 2007 applies to tax on income derived in the 2009 income year onwards). The TP legislation closely follows the current OECD Guidelines and the US Section 482 rules. Other features of the legislation are as follows:

- The basic principle is that of arm's length, as defined by the OECD Guidelines, using five permitted pricing methods: the comparable uncontrolled price (CUP), resale price (RPM), cost plus (CP), profit split (PSM) and comparable profits (CPM) methods.
- The amount of arm's-length consideration must be determined by applying whichever method or combination of methods listed above will produce the most reliable measure that completely independent parties would have agreed on after real and fully adequate bargaining.

- The substitution of an arm's-length price applies only so as to increase New Zealand's tax base (GC 7 and GC 8). (Income Tax Act 2004 Sections GD 13(3) and (4)). The burden of proof as to the arm's-length nature of consideration rests with the commissioner of the Inland Revenue (the commissioner), unless the commissioner can show that the taxpayer has not cooperated or can demonstrate another amount to be a more reliable arm's-length measure (GC 13(4)). (Income Tax Act 2004 Section GD 13(9)).
- There are specific powers, in addition to those in the DTA, to allow compensating adjustments (GC 9 and GC 10 – Income Tax Act 2004 Section GD 13(10)), and corresponding adjustments (GC 13(11) – Income Tax Act 2004 Section GD 13(11)).
- Section GB 2 (Income Tax Act 2004 Section GC 1) contains an anti-avoidance provision that includes arrangements entered into for the purposes of defeating the provisions of GC 6 to GC 14 (Income Tax Act 2004 Section GD 13).

In addition to these outlined provisions, Section YD 5 (Income Tax Act 2004 Section FB 2) stipulates the use of the arm's-length basis to apportion income between New Zealand and other countries in the case of branches and agencies. (In relation to the apportionment of income to branches, the Inland Revenue has made an explicit reservation on the new Article 7 of the OECD model tax convention. The new Article 7 will only apply if and when it is adopted in New Zealand's double tax agreements. The Inland Revenue has stated that this is unlikely to happen in the near future).

Guidance on applying New Zealand's transfer pricing rules

The following additional guidance on the application of the legislation is available from the Inland Revenue:

- A technical information bulletin, which deals with the introduction of the new legislation and provides an indication of how the Inland Revenue will interpret it.
- A TP section on the Inland Revenue website.
- Transfer pricing guidelines.

The Inland Revenue initially released draft guidelines in two parts: part one in October 1997 and part two in January 2000. No subsequent guidelines have been published since the 2007 rewrite of the Income Tax Act 2004.

The first part of the draft guidelines covered the arm's-length principle, TP methodologies, theoretical and practical considerations, principles of comparability, practical application of the arm's-length principle, documentation and the Inland Revenue's approach to administering New Zealand's TP rules. Part two of the draft guidelines covered the treatment of intragroup services, the treatment of intangible property and cost contribution arrangements.

The Inland Revenue issued final TP guidelines (Inland Revenue Guidelines) in October 2000. The Inland Revenue Guidelines consolidate the draft guidelines previously issued, with no substantive changes. The Inland Revenue Guidelines specifically do not apply to permanent establishments (PEs) and branches that are covered by Section YD 5 (Income Tax Act 2004 Section FB 2) of the tax act.

The Inland Revenue states that the Inland Revenue Guidelines are intended to supplement the OECD Guidelines rather than supersede them. In fact, the department fully endorses the comments set out in chapters one to eight of the OECD Guidelines.

New Zealand

In its guidelines, the Inland Revenue indicates that the OECD Guidelines are relevant to DTA issues and issues not addressed by the Inland Revenue Guidelines.

The OECD Guidelines were revised in 2010. The Inland Revenue has noted that it will apply the revised OECD Guidelines, but does not intend to update the Inland Revenue Guidelines to reflect the changes to the OECD Guidelines.

Taxpayers are also directed to guidelines issued by the Australian Taxation Office and the US 482 regulations, as long as these sources are consistent with the overall approach of the Inland Revenue. However, on issues concerning the administration of New Zealand's TP rules, the Inland Revenue Guidelines are stated as being paramount.

The comments in the Inland Revenue Guidelines dealing with the arm's-length principle and pricing methods are broadly consistent with the OECD Guidelines, except there is no explicit hierarchy for the TP methods. However, taxpayers must use the most reliable method.

In relation to the TP methods prescribed in New Zealand's tax act, a particularly interesting comment is made in the Inland Revenue Guidelines:

"… Inland Revenue does not consider that there is any practical difference between the TNMM [transactional net margin method] espoused by the OECD, the comparable profits method favoured in the US, and the profit comparison method adopted by Australia. It was also noted [previously in the Inland Revenue Guidelines] that the reference to 'comparable profits methods' in Section GD 13(7)(e) [of the tax act] is wide enough to encompass all three approaches" (the Inland Revenue Guidelines, paragraph 141). (This reference provided by the Inland Revenue Guidelines refers to the Income Tax Act 2004. The relevant section in the 2007 rewrite is GC 13(2)(e)).

Tested party
With respect to tested parties, the Inland Revenue Guidelines specifically allow taxpayers to benchmark the foreign party in particular circumstances where they believe that that is more appropriate to determine the most reliable measure of the arm's-length price. However, where a taxpayer does decide to use the foreign party as the tested party, it should be aware that the Inland Revenue is likely to also test the New Zealand party and, therefore, it is important there is some analysis in relation to the New Zealand operations. Specifically, the Inland Revenue is prepared to accept a foreign analysis provided that the analysis represents a fair application of the arm's-length principle and results in a return from the New Zealand operations that is, prima facie, commensurate with the operation's economic contribution and risks assumed.

Arm's-length ranges
The Inland Revenue recognises that applying the TP methods can often result in a range of arm's-length outcomes instead of a single arm's-length outcome. Where a range is established, the Inland Revenue considers that, rather than the entity applying statistical measures to the range, the more important issue is to assess whether the comparables used to construct the range are reliable.

Intangibles
The Inland Revenue Guidelines also consider cross-border transfers of intangible property including any rights to use industrial property (such as patents, trademarks,

trade names, designs or models), any literary or artistic property rights (copyrights, etc.) and any intellectual property, such as know-how or trade secrets.

The Inland Revenue acknowledges that the application of the arm's-length principle to transfers of intangible property can be problematic because appropriate comparable transactions can be difficult, if not impossible, to identify. Despite these difficulties, the Inland Revenue emphasises that applying the arm's-length principle is no different than for other types of property.

Services
The Inland Revenue Guidelines also discuss the provision or receipt of intragroup services. Services can be either specific benefit or indirect. Specific benefit services are normally charged to the recipient entity directly. Indirect services should be charged using a cost allocation or apportionment approach.

The Inland Revenue Guidelines depart most significantly from the OECD Guidelines relating to both of the following:

- A detailed discussion of the different allocation methods that may be appropriate in the charging of indirect services.
- The provision of a safe harbour mark-up on cost of 7.5% in applying the CP method for non-core activity services and for services under the specified *de minimis* threshold. (The Inland Revenue has recently updated the *de minimis* threshold from NZD 600,000 to NZD 1,000,000, effective 1 January 2015. This aligns the New Zealand threshold with that applied by the Australian Taxation Office, and therefore reduces compliance costs for multinational enterprises). A non-core activity is defined as an activity that is not integral to the profit-earning or economically significant activities of the group. This provision will relieve taxpayers from having to benchmark these services. However, it does not relieve their obligations to demonstrate the benefits derived from the services or prepare adequate TP documentation.

Cost contribution arrangements
Cost contribution arrangements are also discussed in the Inland Revenue Guidelines. The Inland Revenue Guidelines emphasise that to satisfy the arm's-length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances. Cost contribution arrangements remain an evolving concept from a TP perspective. Taxpayers should clearly consider the Inland Revenue Guidelines on such arrangements if they are participating in or considering participating in one.

Use and availability of comparable information
That a transfer price is at arm's length would, in theory, be demonstrated by means of one or more of the prescribed methods in Section GC 13(2) (Income Tax Act 2004 Section GD 13(7)) of New Zealand's tax act. In practice, unless either a CUP or sufficient data to apply an RPM or CP method is available, justification of the pricing used would almost certainly depend on a comparison of net profit margins. In most cases, unless the taxpayer has information available regarding its competitors and/or CUPs or internal comparable transactions, the taxpayer would depend on information available from commercial databases. This information, likely to be an analysis of published annual accounts, would almost certainly force any defence to be based on the comparison of net profit margins.

In some cases, within particular industries, more detailed information is available, but this is the exception rather than the norm. Because of the small number of independent companies and large number of 'controlled entities', New Zealand taxpayers are often forced to look for comparable entities in foreign jurisdictions (e.g. Australia, the UK or the US). In the absence of New Zealand comparables, the Inland Revenue has stated a preference for Australian comparables, although they recognise that reliable data may also be found in European (particularly the United Kingdom) and United States markets.

Non-publicly available information
The Inland Revenue Guidelines raise the issue of the Inland Revenue's use of non-publicly available information. The Inland Revenue Guidelines state the Inland Revenue does not intend as a matter of course to use non-publicly available information in attempting to substitute an alternative measure of an arm's-length amount. The Inland Revenue concedes there are difficulties including the likelihood that such information could not be provided to taxpayers whose transfer prices are under review because of the secrecy provisions of the Tax Administration Act.

However, the Inland Revenue does not rule out the possibility that non-publicly available information will be used in administering the TP rules because the New Zealand tax act requires that the most reliable measure of the arm's-length amount must be determined.

Use of hindsight
The Inland Revenue Guidelines make it clear that the use of hindsight is inconsistent with the arm's-length principle. However, the Inland Revenue Guidelines state that the use of hindsight may be valuable in appraising the reliability of comparables used. The Inland Revenue Guidelines provide an example of a newly developed intangible being difficult to value because of uncertainty as to its future value. Even if time does prove the intangible to be valuable, this is not grounds for automatically adjusting the transfer price.

Availability
The Inland Revenue could access information on other taxpayers, either during investigations into those taxpayers or through a direct request for information under Section 17 of the Tax Administration Act. The latter would enable the Inland Revenue to obtain precise information. Indeed, a recent comment from the head of the Inland Revenue's International Tax Policy Division indicated that such information might be used to select companies for audit, although it is uncertain whether, or under what authority, information obtained in this way could be used as the basis for TP adjustments.

As noted previously, the information available to taxpayers is likely to be limited to analyses of published accounts as found on commercial databases.

Penalties
The Commissioner has the ability to substitute an amount paid or received if such an amount is not arm's length, to an arm's-length amount (section GC 7 and GC 8 of the Act).

Additional tax and penalties

New Zealand's tax legislation specifies penalties that may be applied to adjustments arising from TP issues. Determination of the penalties focuses on culpability. The shortfall penalties are:

- not taking reasonable care – 20% of tax shortfall
- unacceptable interpretation – 20% of tax shortfall
- gross carelessness – 40% of tax shortfall
- abusive tax avoidance – 100% of tax shortfall, and
- evasion – 150% of tax shortfall.

These penalties can be adjusted up or down to reflect the taxpayer's level of cooperation with the authorities during the investigation and the existence or otherwise to any disclosures to the tax authorities. Penalties are not tax-deductible. In addition to the shortfall penalties, an interest charge (deductible) is automatically applied from the date on which the tax should have been paid to the date on which it is finally paid. The rate is adjusted from time to time to reflect economic circumstances.

Documentation

New Zealand's TP rules do not contain an explicit statutory provision requiring taxpayers to prepare TP documentation. However, Sections GC 6 to GC 14 (Income Tax Act 2004 Section GD 13) of the tax act require taxpayers to determine transfer prices in accordance with the arm's-length principle by applying one (or a combination) of the methods set out in Section GC 13(2) (Income Tax Act 2004 Section GD 13(7)) of the tax act. For an entity to demonstrate compliance with this requirement, the Inland Revenue considers it necessary to prepare and maintain documentation to show how transfer prices have been determined.

The Inland Revenue considers there are two reasons for making this assertion for documentation. The first is the burden of proof rule in Section GC 13(4) (Income Tax Act 2004 Section GD 13(9)) of the tax act. Under this section, the price determined by the taxpayer will be the arm's-length price, unless the commissioner can demonstrate a more reliable measure or the taxpayer does not cooperate with the commissioner's administration of the TP rules. If a taxpayer does not prepare documentation, there are two exposures. First, it is more likely the Inland Revenue will examine the taxpayer's TP in detail. Second, if the Inland Revenue substitutes a new transfer price as a result of the examination, the lack of documentation will make it difficult for the taxpayer to rebut that position.

The second consideration sustaining the Inland Revenue's view of documentation is the proposed application of the penalty provisions of the Tax Administration Act 1994 (Tax Administration Act) contained in the Inland Revenue Guidelines:

'In Inland Revenue's view, adequate documentation is the best evidence that can be presented to demonstrate that these rules have been complied with. If a taxpayer has not prepared any TP documentation, and Inland Revenue is able to demonstrate a more reliable measure of the arm's-length amount, Inland Revenue's view is likely to be that the taxpayer has, at a minimum, not exercised reasonable care (carrying a 20% penalty under Section 141C of the Tax Administration Act) or has been grossly careless (carrying a 40% penalty under Section 141C of the Tax Administration Act), in its determination of an arm's-length amount under Section GD 13 (the Inland Revenue

Guidelines, paragraph 316). (This reference from the Inland Revenue Guidelines refers to the Income Tax Act 2004. The corresponding references for the Income Tax Act 2007 are GC 6 to GC 14).

The Inland Revenue accepts that the creation and maintenance of documentation impose costs on taxpayers. In the Inland Revenue's opinion, if a taxpayer has reached the conclusion on the basis of a sensible cost-benefit analysis that it is not prudent to pursue a full TP analysis, this would be strongly suggestive that the taxpayer has taken reasonable care. Of course, the Inland Revenue would expect to see a document explaining how the conclusion was reached. In respect of the issue of whether a taxpayer has an acceptable interpretation, the Inland Revenue considers that the taxpayer must have explicitly considered that its transfer prices are at least broadly consistent with the arm's-length principle. In assessment of the risk of a potential TP adjustment, all of the following documentation is suggested at a minimum:

- An identification of the cross-border transactions for which the taxpayer has a TP exposure.
- A broad functional analysis of the taxpayer's operations to identify the critical functions being performed.
- An estimate of the business risk of not undertaking and documenting a more detailed TP analysis.
- An estimate of the costs of complying with the TP rules.

It is emphasised that this assessment will not preclude the Inland Revenue from substituting a more reliable measure of the arm's-length price. Where a cost-benefit analysis indicates the need for a full analysis, the Inland Revenue would expect to see all of the following documentation:

- Some form of functional analysis.
- An appraisal of potential comparables.
- An explanation of the process used to select and apply the method used to establish the transfer prices and why the taxpayer considers that it provides a result consistent with the arm's-length principle.
- Details of any special circumstances that have influenced the price set by the taxpayer.

It should be noted that these documentation requirements have no legislative authority and are not, therefore, binding on the taxpayer. Rather, they are an indication of the Inland Revenue's approach to an interpretation of New Zealand's TP rules.

Transfer pricing controversy and dispute resolution

Inland Revenue's review mechanism

The main tool that the Inland Revenue uses in assessing taxpayers' compliance with the TP rules is its TP questionnaire. There are three versions of the questionnaire: one for foreign-owned multinationals, one for New Zealand-owned multinationals and one for New Zealand branches. They vary slightly; however, they ask the same main questions.

The questionnaire requires taxpayers to provide details of, among other things: their financial performance; the worldwide group's financial performance; the type and amounts of cross-border, associated-party transactions; the method or methods used to test the transactions; and whether documentation exists to substantiate the

transfer prices. The version pertaining to foreign-owned multinationals also includes questions designed to assess taxpayers' compliance with the thin capitalisation rules. The questionnaire is a risk assessment tool and does not constitute notice of the commencement of a TP audit.

The Inland Revenue first issued the questionnaires as part of its TP risk review project (i.e. 'bulk' rounds of questionnaires sent to multiple taxpayers) and during general tax audits. The department issued two rounds of questionnaires in 2000 and a further round in December 2003. Since then, questionnaires have remained central to the Inland Revenue's compliance programme as a means of scoping risks efficiently and effectively.

Taxpayers with potential TP issues receive the questionnaire as standard practice during a tax audit. We also have seen an increasing number of taxpayers being asked by the Inland Revenue to complete questionnaires during routine tax investigations. In many cases, a request for TP documentation has accompanied the issuance of the questionnaire during a tax audit. Inland Revenue auditors have received training specific to TP, and recent experience suggests an increasing number of auditors are making TP queries.

Some taxpayers have also received the questionnaire as a 'one-off,' not as part of a specific review project or a tax audit. We suspect that in these incidences, the Inland Revenue is seeking to obtain an understanding of the TP issues and risks associated with a particular industry.

The types of response the Inland Revenue gives a taxpayer following submission of the questionnaire include 'no further action required', 'please provide further information' and 'please explain.' In the second of these responses, the Inland Revenue generally requests the taxpayer to complete a further questionnaire for a subsequent financial year. The third response usually entails the Inland Revenue requiring the taxpayer to explain the nature of a particular (and perhaps unusual) transaction or the reasons for a loss being incurred.

In addition, the Inland Revenue has indicated to some taxpayers that have received the questionnaire that it is maintaining a 'watching brief' of their TP practices. The department monitors the financial performance of these taxpayers by accessing publicly available financial statements from the New Zealand Companies' Office website.

Legal cases
No court cases have arisen in connection with New Zealand's current TP rules. It should be noted, however, that even under the previous legislation, there were effectively no TP court cases in the 20 years prior to its repeal. The two main reasons for this are:

- The previous legislation was considered to be defective.
- Most TP disputes were settled by negotiation, there was no need to proceed to court.

Burden of proof
In New Zealand, the burden of proof normally lies with the taxpayer, not the commissioner. However, Section GC 13(4) (Income Tax Act 2004 Section GD 13(9)) places the burden of proof on the commissioner where the taxpayer has determined its transfer prices in accordance with Sections GC 13(1) to 13(3) (Income Tax Act 2004 Sections GD 13(6) to 13(8)) of the tax act.

Where the commissioner substitutes an arm's-length price for the actual price, the commissioner must prove one of the following:

- This is a more reliable measure.
- The taxpayer has not cooperated with the commissioner.

According to the Inland Revenue Guidelines, non-cooperation constitutes either of the following:

- Where the taxpayer does not provide the requested relevant information to the commissioner.
- If a taxpayer does not prepare adequate documentation and provide it to the Inland Revenue if requested.

The burden of proof rule is essential in the context of TP in New Zealand. Clearly, if taxpayers maintain quality TP documentation and produce it on request to the Inland Revenue, this will substantially reduce the risks of an intensive TP audit. And in any event, the burden of proof will fall on the commissioner to demonstrate that the Inland Revenue has a more reliable measure of the arm's-length price.

Tax audit procedures
The Inland Revenue will perform audits or investigations specifically for TP issues. Transfer pricing audits or investigations may also be combined with normal tax audits and investigations.

Selection of companies for audit
Whether a company or group is selected for investigation will depend on a variety of factors or situations including:

- Previous TP disputes with the tax authorities, particularly if the authorities consider that these were unsatisfactorily resolved.
- The industry in which the company operates.
- Where an application for an APA has been withdrawn or unsatisfactorily resolved.
- Following receipt of information passed to the tax authorities from overseas.
- Where there is evidence of TP disputes with other revenue authorities overseas.
- As a result of desk audits of returns and replies to correspondence seeking information.
- Inland Revenue risk assessment by reference to all of the following:
  - Level of profitability.
  - No evidence of negotiations with parent.
  - No economic or commercial basis for price.
  - Poor cooperation.
  - Limited TP documentation.

The Inland Revenue compliance programme focuses its resources on perceived risk to the New Zealand tax revenue base. A TP-specific review ultimately depends on the extent of tax risk perceived in the taxpayer's TP practices. The Inland Revenue Guidelines indicate that the Inland Revenue is likely to inspect transactions involving an entity resident in a country in which New Zealand does not have a DTA more closely than transactions involving tax treaty countries.

Risk transactions or industries

The transactions which can be attacked are specified in Sections GC 6(2) and GC 6(3) (Income Tax Act 2004 Section GD 13(2)) of the Income Tax Act 2007. Particular types of payment or receipt that are likely to be targeted include payments of interest, management fees, royalties and other fees in relation to intangibles, along with fixed-rate preference shares. Effectively, the only item that is excluded is share capital other than fixed-rate preference shares.

The Inland Revenue has indicated that as part of its compliance review programme, it will focus on significant business restructurings, transactions involving intangibles and financing arrangements.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Information that tax authorities can request during investigations and the authorities' powers to enforce provision of the information are outlined in Sections 16, 17, 17A, 18, 19 and 21 of the Tax Administration Act. The most important are Sections 16 and 17, which give the Inland Revenue extensive powers, both to carry out investigations and to demand information.

The Inland Revenue Guidelines make it clear that the Inland Revenue expects New Zealand taxpayers on request to obtain information from overseas associated entities to justify the arm's-length nature of their transfer prices. Section 21 provides the Inland Revenue with further powers to require information, particularly in respect of information held offshore. Any information that is not produced in response to a Section 21 request will not be available to the taxpayer as part of his/her defence in any subsequent court action relating to such matters.

Effective 22 June 2005, taxpayers can claim a right of non-disclosure for certain tax advice in documents prepared by tax advisers. However, this right of non-disclosure can be claimed only in respect of 'tax advice documents.' The Inland Revenue has issued a standard practice statement (SPS 05/07) to provide guidance to taxpayers on this matter. The definition of 'tax advice documents' in the Inland Revenue's standard practice statement excludes TP reports.

Investigations in New Zealand are conducted by way of visits to the taxpayers' premises and interviews with relevant personnel. In some cases, these visits may be preceded by requests for the provision of documentation.

Usually in New Zealand, an investigation is decided through negotiation, but it may proceed to litigation if the issues raised cannot be resolved through negotiation. There is also a dispute resolution procedure that applies to TP disputes. This provides a form of dispute resolution that is primarily aimed at attempting to settle prior to an assessment. During this procedure, notice of intended assessment is given, followed by compulsory meetings. At the meetings, full disclosure of all relevant facts is required to be made, and it should be noted that any information not produced for these meetings is banned from any future court action.

Revised assessments and the appeals procedure
Appeals start with the dispute resolution procedure. After the taxpayer proceeds completely through the dispute resolution procedure, any further appeal would be heard by the courts.

Resources available to the tax authorities
The Inland Revenue has advised that in the first instance TP will not be dealt with by a separate, discrete TP unit. Rather, all tax inspectors and auditors will be capable of handling TP issues. However, the Inland Revenue has a small team of TP specialists, who typically work alongside the inspectors during a tax audit and/or undertake their own TP-specific audits. The Inland Revenue has economists available as part of its staff resources and it is clear the department will not hesitate to contract with outside experts, both economists and industry experts, to assist with its deliberations.

The Inland Revenue has recently restructured the International Audit Team to separate compliance and strategic activities. This will allow the Inland Revenue to focus on long-term compliance issues and key risk areas such as those discussed above.

Limitation of double taxation and competent authority proceedings
The competent authority process in New Zealand operates in the way set out in a typical DTA, with nominated officers of the Inland Revenue acting as competent authorities for particular topics. The head of the International Tax Policy Unit is the competent authority for TP matters.

In addition to DTA provisions, specific provisions in the New Zealand tax act provide for both corresponding adjustments and compensating adjustments, but only in consequence of adjustments made in New Zealand, not in consequence of foreign adjustments.

Advance pricing agreements
APAs are available to taxpayers in New Zealand, and historically the Inland Revenue has been keen to see a greater number of taxpayers seeking APAs. The Inland Revenue has established its APA programme under a broad framework using informal procedures and has stated it will not issue formal APA guidelines. The Inland Revenue considers that its flexible approach to APAs minimises the possibility of the process becoming too bureaucratic and enhances the efficiency of its APA programme. This flexible approach means that, to date, most unilateral APAs have been concluded within six months. New Zealand APAs are particularly efficient where APAs have previously been agreed by offshore affiliates with other revenue authorities (where the offshore affiliates are functionally similar to the New Zealand taxpayers).

The Inland Revenue concluded its first bilateral APA (with Australia) in 2001. Since then, the Inland Revenue has concluded several other bilateral APAs with Canada, Japan, Korea, Switzerland, Belgium and the US. The department is also party to a multilateral APA. The Inland Revenue has concluded over 120 APAs and is currently negotiating a number of others. Key areas covered by APAs that have been negotiated recently include distribution entities with large exposures, business restructures and complicated royalty structures.

The Inland Revenue continues to encourage taxpayers to seek unilateral and bilateral APAs (particularly with Australia), as it believes it is better for taxpayers to obtain APAs than run the risk of potentially costly and time-consuming TP audits. Its view is that given the subjective nature of TP, APAs are the best way for taxpayers to achieve certainty. Our experience with the Inland Revenue in relation to APAs has been positive, although we note that the current global focus on BEPS and TP has led to increased challenges for taxpayers when applying for and agreeing APAs with the Inland Revenue.

Liaison with customs authorities
The Inland Revenue will normally obtain information from the customs' authorities and, in fact, is expected to use customs specifically as a source of TP information. Indeed, customs' officers are currently very active in checking the transfer price of goods, although this is ostensibly for customs' duty purposes. However, customs has raised queries specifically for the purpose of actively sharing information with the Inland Revenue in relation to the price of goods being imported into New Zealand.

Although there is no legislation that directly requires TP adjustments to be reflected in returns made for customs or other indirect taxes, where transfer prices have been adjusted for income tax purposes, this may require customs to review the prices for customs' duty.

The Inland Revenue is currently working with the New Zealand Customs to better align their enforcement practices, taking into account developments overseas.

Joint investigations
New Zealand would undoubtedly join with another country to undertake a joint TP investigation of a multinational group. To this end, there is a formal, but private, agreement already in existence between the New Zealand and Australian tax authorities. In the past, the tax authorities have traditionally cooperated informally with other tax authorities, either in providing information for other TP investigations or, in some cases, participating in joint audits or enquiries.

A mutual administrative assistance is designed to enable multiple countries to work together to counteract international tax avoidance and evasion by sharing information and undertaking joint tax audits. New Zealand is considering signing up to the convention. If it does so, the convention would give the Inland Revenue the ability to enter into joint tax audits with tax authorities in other countries that are signatories.

Comparison with OECD Guidelines

OECD issues

New Zealand is a member of the OECD. It has signed off on the OECD Guidelines and, as discussed previously, has stated express agreement with them. (The Inland Revenue has made an explicit reservation on the new Article 7 of the OECD model tax convention. The new Article 7 (and any associated guidance issued by the OECD) will only apply if and when it is adopted in New Zealand's double tax agreements. The Inland Revenue has stated that this is unlikely to happen in the near future). Further, Inland Revenue personnel are involved in a number of OECD committees dealing with TP issues.

Going forward the Inland Revenue does not intend to update the New Zealand TP guidelines. Instead, the Inland Revenue now relies on the latest 2010 OECD Guidelines, which are consistent with New Zealand's TP legislation and double taxation treaties.

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Overview

With its wealth of natural resources and economic potential, Nigeria is an emerging market attracting attention and investment from foreign businesses in diverse industries – from oil and gas to financial services. This has been further strengthened by the recent rebasing of Nigeria's gross domestic product (GDP), which makes the country the largest economy in Africa. The Federal Inland Revenue Service (FIRS) is keenly aware of the growing number of inter-company transactions between foreign businesses and their local affiliates resulting from these business ventures and has established new transfer pricing (TP) rules, ostensibly to address the perceived shifting of income by foreign taxpayers out of Nigeria. Corporate taxpayers and their advisers currently conducting or anticipating business ventures in Nigeria should educate themselves on the new rules and understand how the trends and precedents set by this recent legislation may impact their own business strategy in the region.

The Income Tax (Transfer Pricing) Regulations No.1, 2012 were released on 21 September 2012 with a commencement date of 2 August 2012. The Regulations are effective for accounting periods beginning after the commencement date.

In the past year, changes have been introduced within the administrative structure of the FIRS in order to build capacity in this area. There is now a dedicated TP division within the FIRS with specialised members – although relatively small in size – dedicated to TP issues. The renewed focus of the FIRS has brought about increased awareness of this new development among corporate entities operating in Nigeria. Where companies have carried out related-party transactions, they are required to submit TP Declaration and Disclosure forms with their annual corporate income tax returns. These forms allow the FIRS to assess the TP tax risk of a taxpayer and make decisions regarding audit selection or request for detailed documentation. Accordingly, increasing attention is being given by the FIRS to related-party transactions, especially with foreign affiliates.

Nigeria

Country	Nigeria
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Upon request by the FIRS within 21 days. In principle, documentation should be in place by the due date for filing income tax returns.
Must TP documentation be prepared in the official/local language?	Yes (official language, i.e. English)
Are related-party transactions required to be disclosed on the tax return?	Yes (in a separate TP Disclosure form)
Penalties	
Are there fines for not complying with TP documentation requirements?	No (fines are, however, imposed on TP adjustments, if any)
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	There are no separate penalties for TP purposes. Any TP adjustment resulting in additional tax liability attracts a penalty as prescribed in the relevant tax law.

Introduction

The need for a specific TP legislation in Nigeria was necessitated by the lack of guidance in the existing tax laws regarding arm's-length principle. Before the introduction of the TP legislation, the FIRS's attempt to capture related-party transactions have always been dealt with under the general anti-avoidance rules (GAARs), specifically within the provisions of section 17 of the Personal Income Tax Act (2004), section 22 of the Companies Income Tax Act (2004, amended 2007), and section 15 of the Petroleum Profits Tax Act (2004). These provisions allow the FIRS to adjust inter-company transactions regarded as producing results that artificially reduce taxable income in Nigeria.

The language of the above provisions, however, makes the determination of acceptable TP a subjective exercise. This situation consequently created a high level of uncertainty and arbitrariness in relation to the manner with which the FIRS determines adjustments in connection with related-party transactions.

Emerging trends within the Nigerian economy has since brought forth the significance of having in place a clear guide for taxpayers and the FIRS to address existing concerns and better deal with the growing level of economic activities. The Nigerian TP legislation is therefore very significant for a number of reasons including:

- With the largest population on the African continent, Nigeria is a very important market for multinationals and the country has been recognised by prominent members of the global investment community and economists as an up-and-coming market with tremendous growth potential over the next several decades.
- As the largest oil producer in Africa and the eleventh largest in the world; together with a very vast deposit of underexploited mineral resources including coal, bauxite, gold and iron ore; Nigeria's natural resources have attracted the attention of major oil and gas multinationals, and other businesses in the allied industries including oil field equipment and services, transportation and logistics, and petrochemicals and plastics.
- An increasing number of local companies within the country, particularly the telecommunications and financial industries have extended their businesses across international borders, especially within the sub-Sahara African region.
- As an emerging economy, the provisions of the Nigerian GAAR in the attempt to capture artificial transactions have become very basic and inefficient in dealing with the increasingly sophisticated transactions that are being carried out by multinationals within the Nigerian economy.

The need to plug the potential leakage of economic resources and erosion of tax through inter-company activities, among others, encouraged the introduction of the Income Tax (Transfer Pricing) Regulations No 1, 2012. The new TP legislation, in addition to providing the legal framework for the implementation of the TP regime in Nigeria, now gives clearer guidance for the enforcement of the statutory provisions contained in the GAAR. The regulations, as provided under regulation 3, cover transactions between connected persons which have been carried out in a manner not consistent with the arm's-length principle. The compliance obligations of the taxpayers under the new legislation include preparing contemporaneous TP documentation and filing TP declaration and TP disclosure forms.

Although the proper enforcement of the new regulations is expected to address the shortcomings of the GAAR in this area and in turn improve the revenue generating capacity of the FIRS, the adequate capability of the tax authority to properly monitor potentially harmful TP tax planning still poses a great challenge. At the heart of the challenge facing the FIRS is the lack of capacity to follow, implement and monitor TP mechanisms occurring within multinationals and domestic groups of companies that operate in Nigeria. Presently, the staff strength of the TP division within the FIRS is inadequate. Given the level of multinational activities presently going on in Nigeria, this is suggestive of the potential level of delay that taxpayers will face in addressing any TP issues they may have with the FIRS.

The Regulations, however, made provision under regulation 7 for connected taxpayers to enter into APAs either with the FIRS alone or together with the competent authority of countries of their connected taxable person. . The application and processing of an APA with the FIRS is free. Nevertheless, there is a threshold of a minimum annual transaction value of 250 million Nigerian naira (NGN) (about 1.2 million United States dollars [USD]). In addition, negotiation of an APA process with the FIRS has been put on hold for at least three years from the commencement of the rules due to inadequate capacity.

Consistency between the Nigerian TP Regulations and the OECD Guidelines
Although Nigeria is not a member of the Organisation for Economic Co-operation and Development (OECD), the application of its TP rules are largely consistent with the provisions of the TP Guidelines as published by the OECD. Regulation 11 of the Nigerian TP legislation states that the provisions of the TP Regulations shall be applied in a manner consistent with the OECD and United Nations (UN) documents on TP. Specifically, the Nigerian TP Regulations are based on the demonstration of the arm's-length principle by taxpayers as articulated in Article 9 of the OECD Model Tax Convention on Income and Capital. Further, the acceptable methods for demonstrating compliance with the arm's-length standard under the Nigerian TP legislation are as outlined in Chapter II of the OECD TP Guidelines for Multinational Enterprises and Tax Administrations, which was approved by the Council of the OECD for publication on 22 July, 2010. Regulation 5 further provides that the FIRS may prescribe any method in the regulations from time to time. The Nigerian TP Regulations however make provisions under regulation 12 for the supremacy of the tax law where any inconsistency exists between the OECD or UN documents and the provisions of the relevant Nigerian tax laws.

Legislation and guidance
There are several sections within the Nigerian tax statutes which place on taxpayers the obligation to ensure that related-party transactions are conducted at arm's length. These include:

- Section 17 of the Personal Income Tax Act, 2004.
- Section 22 of the Companies Income Tax Act, 2004 (as amended by the Companies Income Tax [Amendment] Act 2007).
- Section 15 of the Petroleum Profits Tax Act, 2004.

The Nigerian TP regulations (i.e. Income Tax [Transfer Pricing] Regulations No 1, 2012) provide guidance on the application of the arm's-length requirement of the above statutes. The requirements apply to both local and cross-border related-party transactions.

Under the Regulations, affected taxpayers are required to put in place TP documentation to support the arm's-length nature of their related-party transactions. There is no requirement to submit the documentation except where a request is made by the tax authorities. The documentation must be provided within 21 days of such a request. However, taxpayers are to submit at the time of filing, the annual income tax returns, completed TP declaration and disclosure forms on their related-party transactions.

Also, there are no materiality thresholds for documentation. The Regulations, nevertheless, include safe harbour provisions whereby a taxpayer could be exempt from the documentation requirements by the FIRS. This would apply where the controlled transactions are priced in line with the requirement of Nigerian statutory provisions or where the prices of connected transactions have been approved by Government regulatory authorities and the FIRS is satisfied that they are at arm's length.

In addition, even though the regulations do not specifically state the type of information to be included in the TP documentation, there are provisions which suggest that the OECD's recommended documentation approach will be an acceptable standard.

The FIRS has recently provided a number of taxpayers with a non-exhaustive list of information which the taxpayers are expected to provide as part of their TP documentation.

Other regulations

The National Office for Technology Acquisition and Promotion

The National Office for Technology Acquisition and Promotion (NOTAP) was set up to facilitate the transfer of technology by foreign enterprises to Nigerian enterprises. As part of its mandate, NOTAP must approve all contracts involving the transfer of technology between a non-resident company and a Nigerian company. These include contracts involving the use of intellectual property (IP), the provision of management and technical services, secondments, etc. Without NOTAP approval, the Nigerian beneficiary of the IP or service will not be able to source the foreign exchange (from the Nigerian banking system) required to pay its non-resident service providers.

At present, the NOTAP approval process does not involve any detailed or systematic arm's-length analysis.

Prior to the introduction of the TP legislation, the FIRS used the NOTAP approval as a basis for granting tax deductions for the relevant expense in many cases. However, with the introduction of the TP rules, where the FIRS does not consider the prices approved by NOTAP to have satisfied the arm's-length principle, Regulation 12(2) accordingly states that the provision of the Nigerian TP Regulation shall prevail in the event of inconsistency with other regulatory authorities' approvals.

Given the potential for conflicts between the approved amount based on NOTAP's review and the arm's-length amount based on a TP analysis, it is pertinent that taxpayers proactively engage both regulatory authorities to reach a consensus on an appropriate methodology for pricing their transactions. Taxpayers will need to obtain a NOTAP approval and also support the prices paid for the relevant intercompany transactions (e.g. technical services) with a TP analysis that demonstrates the arm's-length nature of the transfer prices.

The Nigerian Stock Exchange Rules on Interested Party Transaction
The Nigerian Stock Exchange (NSE) has set out rules to govern interested party transactions (the Rules). The Rules which were approved by the Securities and Exchange Commission (SEC) in May 2014 became effective from 1 November 2014. The Rules are targeted at companies that have equity securities listed on the NSE i.e. 'the issuer'. It seeks to guard against the risk that 'interested persons' could influence an 'entity at risk' to enter into transactions that may negatively affect the listed entity or its securities holders. An 'entity at risk' includes the issuer of securities, a subsidiary of the issuer that is not listed on the NSE, or an associated company of the issuer that is not listed on the NSE provided the issuer, its group or interested person(s), has control over the associated company. 'Interested person' include a director, chief executive and controlling shareholder of the listed company including persons connected to these persons.

The Rules are applicable to interested party transactions with a value of 5% of the issuer's latest audited net tangible assets or issued share capital. The transactions covered include the provision or receipt of financial assistance, the acquisition, disposal or leasing of assets, the provision or receipt of services, the issuance or subscription of securities, the granting of or being granted options; and the establishment of joint ventures or joint investments.

Some of the compliance obligations imposed by the Rules require a listed entity to:

- make certain disclosures in the annual report
- obtain approval from securities holders for any interested person transaction of value or aggregate value of at least 5% of the listed company or its group's tangible net assets or issued share capital, and
- in certain circumstances, obtain an opinion from an independent financial advisor on whether the methods and procedures are sufficient to ensure that the transactions shall be carried out on normal terms and shall not be prejudicial to the interest of the issuer and its minority shareholders.

The NSE Rules are designed to protect minority investors in listed companies. While the TP Regulations seek to ensure that taxpayers pay their taxes on the appropriate taxable basis, the NSE Rules seek to guard against transactions that adversely affect minority shareholders. Generally, both the TP Regulations and NSE Rules seek to ensure that transactions are priced based on the prevailing market conditions and at commercial terms. It is however not clear if the NSE would accept transfer pricing analysis prepared for tax purposes as evidence that an affected transaction has been conducted at normal commercial terms.

Penalties
There are no specific penalties for contravening the provisions of the Nigerian TP legislation. Regulation 13 of the TP legislation, however, stipulates that a taxable person who contravenes any of the provisions of the Regulations shall be liable to a penalty as prescribed in the relevant provision of the applicable tax law. For example, where an offence has been committed and contravention of the provisions of the Nigerian TP legislation has been established in respect of a company liable to tax under the Nigerian Companies Income Tax Act (CITA), the determination of the applicable penalty and interest for any resulting TP adjustments made by the FIRS shall be in accordance with the provisions of sections 55(3)(5) and 85(1) [Offences and Penalties] of the CITA.

Documentation

Regulation 6 of the Nigerian TP regulations specifically requires connected taxpayers to maintain relevant documentation which will allow the FIRS to verify that the pricing of controlled transactions is consistent with the arm's-length principle. Such compliance documentation must be prepared, taking into account the complexity and volume of transactions involved. However, the FIRS reserves the right to specify the items of documentation required to be provided upon request. By retaining the necessary documentation, the FIRS shall consider this as an adequate first step to verify that the controlled transaction is consistent with the arm's-length principle.

Under the Nigerian TP legislation, connected taxpayers are required to complete/ provide the following annually:

- **The TP Declaration form:** Connected taxpayers who have carried out related-party transactions in a financial year are required to complete and append this form to their tax returns for the year to which it relates. The TP declaration form contains information on:
  - particulars of the reporting company
  - particulars of immediate parent company
  - information about the directors of the reporting entity
  - major shareholders of the reporting company, i.e. persons owning 10% or more of reporting entity
  - ownership structure of the reporting company
  - subsidiaries and other connected persons
  - particulars of external auditors of reporting company
  - particulars of tax consultants of reporting company
  - particulars of company secretary of the reporting company,
  - particulars of the person making the declaration, and
  - a declaration completed and signed by a Director or the Company Secretary.
- **The TP Disclosure form:** Together with the TP declaration form, connected taxpayers are also required to complete a TP disclosure form. This form is to be completed and submitted with the tax returns for the year to which it relates. Taxpayers are required to disclose information in relation to:
  - particulars of the reporting company
  - income from controlled transactions
  - cost of controlled transactions
  - TP method used for the tested transaction
  - The fact that they have TP documentation in place
  - basic financial information given in the reporting currency used in the financial statements,
  - particulars of the person making the disclosure, and
  - a declaration completed and signed by a Director or the Company Secretary.
- **The TP Documentation report:** This is a compliance documentation report which is meant to evidence how the TP practices of the taxpayer have been implemented. In principle, a connected taxpayer must have a TP documentation report in place prior to the due date for filing the income tax return for the year in which the documented transactions occurred. This documentation must be provided to the FIRS upon request within 21 days. However, where a reasonable request is made by a connected taxpayer, the FIRS may extend this deadline.

Once a taxpayer is able to provide required documentation in order to support the consistency of the taxable profits derived from its controlled transactions with the arm's-length principle, Regulation 6(10) of the TP legislation provides that a taxpayer will be regarded as having satisfied the burden of proof imposed on them that the conditions of the controlled transactions are consistent with the arm's-length principle.

Although there are no clear outlines in the Nigerian TP legislation in relation to the specific details that should be provided in a TP documentation report, the regulations give the FIRS the power to specify the content of such documentation.

The FIRS has recently written to a number of taxpayers providing them with a non-exclusive list of information expected to be included in their TP Documentation. This is summarised below:

- Taxpayer specific information: profile of the reporting entity and its businesses, including but not limited to organisational structure, business outline including list of all products or services, description of business strategy, environment, value chain, amount of revenue and operating results for preceding five years etc.
- Group specific information: profile of the group which the reporting entity is a part of, including name, address, legal status and country of tax residence of each entity in the group, a general description of the businesses of the entities in the group, the industry in which they operate, group operating results for preceding five years etc.
- Transaction specific information: detailed description of controlled transactions including quantum, value and type of such transaction, terms and conditions of sale or transfer, breakdown of costs of product or service into their various components where applicable etc.
- Transfer price(s) specific information: information including transfer price for each of the controlled transaction, TP method adopted, functional analysis, bench-marking reports including 'acceptance and rejection matrix' and justification for rejection etc.
- Other relevant information: agreements and contracts entered into with connected persons and with unrelated persons for transaction amongst the group members, such other documentations as may be considered necessary by the taxpayer(s), to justify arm's-length pricing of their controlled transactions etc.

Although the TP legislation does not contain any detail about the need for taxpayers to have a TP policy report in place, the FIRS has in the past asked taxpayers to provide their TP policies ahead of their income tax returns' filing deadline.

TP controversy and dispute resolution

TP audit procedures

To a large extent, the current methodology employed for general tax audits is being maintained for TP specific audits. At the moment, tax audit reviews by the FIRS usually take the form of a desk examination or field audit. The desk examination is not typically an intensive exercise since the queries are usually limited to observations made by the FIRS on the tax returns that have been submitted. At present the majority of audit activity is a desk examination being conducted for the purpose of TP risk assessment.

The field audit process (which is an intensive audit exercise) involves field visits by the FIRS's officers to the taxpayer. Although the actual field exercise usually lasts between two to four weeks, the resolution of audit matters could take months or years. A taxpayer who is unable to reach an agreement with the FIRS on any matter is allowed to make an appeal to the Tax Appeal Tribunal. Where the Tribunal's ruling is still not satisfactory to the taxpayer, there is an option to further appeal to the regular courts.

Burden of proof

Under the Nigerian TP regulations, the burden of proof that the conditions of the controlled transactions are consistent with the arm's-length principle is that of the taxable person. The current regulations provide that this burden of proof will be satisfied if the taxpayer provides TP documentation that is consistent with the requirements of the regulations.

Legal cases

There are no specific court cases yet on TP in Nigeria.

Dispute resolution

The Nigerian TP regulations require FIRS to set up a Decision Review Panel (DRP) for the purpose of resolving any dispute or controversy arising from the application of the TP regulations. A taxpayer who disagrees with the ruling of the DRP on any TP matter has recourse to the Tax Appeal Tribunal in the first instance and then to the courts.

Advance pricing agreements (APAs)

Regulation 7 of Income Tax (Transfer Pricing Regulations), 2012 made provision for taxpayers to negotiate APAs with the FIRS. The regulations indicate that a taxable person may request either a unilateral, bilateral or multilateral APA. Application for an APA is free. However, this can only be made where the annual value of the related-party transaction is not less than NGN 250 million (approximately USD 1.2 million).

The FIRS has, however, put its APA programme on hold at least for 3 years (starting from FY 2013).

Mutual agreement procedure (MAP)

The TP Regulations do not contain specific MAP options for taxpayers. The Regulations, however, in articulating the FIRS's willingness to make corresponding adjustment where necessary, implicitly recognise the MAP provisions which exist in Nigeria's DTTs.

There is little information available on the process for competent authority claims. Experience suggests that the competent authority process has been rarely used in Nigeria, but discussions are on-going on ways to improve this.

Comparison with OECD Guidelines

Although Nigeria is not a member of the OECD, the OECD Guidelines will be relevant for determining the arm's-length standard for Nigerian TP purposes. The TP regulations state clearly that the provisions will be applied in a manner consistent with the OECD TP Guidelines.

In addition to references to the OECD Guidelines, the regulations also permit the use of the UN Practice Manual as a guide. This has the potential of creating issues in the event of a conflict between interpretations contained in the UN Manual and the OECD Guidelines.

In any case, Regulation 12 of the Nigerian TP rules states that the provisions of the relevant tax laws shall prevail where any inconsistency exists between the provisions of any applicable law, rules, regulations, the UN Practical Manual on TP or the OECD documents referred in the Regulations.

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Norway

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Overview

Norway is a member of the Organisation for Economic Co-operation and Development (OECD), and the OECD Transfer Pricing (TP) Guidelines are integrated in Norwegian tax law through the General Tax Act (GTA) Section 13-1. Detailed TP documentation rules were introduced in 2007, through the Tax Assessment Act (TAA) section 4-12. According to section 4-12, all companies are obliged to report internal transactions through a mandatory form attached to the annual returns. The documentation rules became effective from fiscal year 2008.

Thin capitalisation/interest deduction rules were introduced in 2012 through the GTA section 6-41. According to the section, deductible internal interest cannot exceed 30% of taxable earnings before interest, taxes, depreciation and amortisation (EBITDA). There is also special TP legislation for upstream companies in the Petroleum Tax Act (PTA) regarding the sale of crude oil and some other petroleum products, and interest deductions.

TP has been high on the Norwegian tax authorities' agenda for many years, especially in the petroleum industry, but also in other industries. The tax authorities have several specialised groups of lawyers and economists (auditors) working only within TP, which has resulted in a high number of TP-tax audits. A notable feature of Norway's general TP-climate is the willingness of companies to challenge the tax authorities' decisions in court, resulting in a relatively high number of court cases (approximately 40).

Country	Norway
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	N/A

Norway

Country	Norway
When must TP documentation be prepared?	Contemporaneously, at the latest delivered 45 days from the tax authorities' request
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed in the tax return documentation?	Yes, through mandatory form RF 1123.
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Introduction

In Norway, the arm's-length standard for related-party transactions is incorporated into the GTA 1999 section 13-1. TP documentation rules became effective from fiscal year 2008. The GTA section 13-1(4) makes reference to the OECD TP Guidelines. These 'shall be taken into account'. The reference is to the guidance on the arm's-length principle and the TP methods. It is assumed that the reference includes the OECD guidance on business restructuring.

The Norwegian tax authorities consider TP as a priority and have considerable resources. It is fairly common for the Norwegian tax authorities to pick test cases that are subject to substantial investment. Such cases may easily end up in court. Settlements have traditionally not been common, but are now more frequent during TP audits.

During recent years, the tax authority attention has been *inter alia* on intragroup financing arrangements, intragroup services, business restructuring and commissionaire arrangements. Audits of companies having low or negative margins are also frequent.

Norway does not have a general advanced pricing agreement (APA) regime, although a formal APA can cover certain transactions related to the sale of gas. Nevertheless, it is becoming more common to discuss complex cases with the tax authorities in advance of implementation or before the tax assessment. PwC concluded in May 2011 the first unilateral advance 'agreement' regarding the value of intellectual property (IP) and business activity to be sold by a Norwegian company to foreign affiliated companies. In December 2011, PwC negotiated and agreed with the tax authorities on behalf of a client the valuation of certain assets to be sold by a Norwegian company to a foreign affiliated company prior to the transaction being carried out. Thereafter, PwC has negotiated several agreements in advance.

Legislation and guidance

Statutory rules – General Tax Act section 13-1

A general arm's-length rule is laid down in section 13-1(1) of the GTA. The section provides that, where the income of a Norwegian taxpayer is reduced, due to transactions with a related party, the authorities may adjust the taxable income.

The following three conditions must be met for the tax authorities to adjust a taxpayer's taxable income or assets in accordance with the GTA section 13-1:

- The parties involved in the transaction must have a direct or indirect community of interest.
- There must be an income or wealth reduction (compared with what the situation had been had the parties not been related).
- The income or wealth reduction must have occurred as a consequence of the relationship (the community of interest) between the parties. Where the related party is resident outside the European Economic Area (EEA), the legislation assumes that the relationship is the reason for any deviation from arm's-length income or wealth, and puts the onus on the taxpayer to prove otherwise.

Section 13-1(3) states the income adjustment shall be as if the parties were unrelated. The Supreme Court made some interesting statements regarding the burden of proof in the 1999 Baker Hughes case (*see Burden of proof, below*). The conditions according to section 13-1(1) can be tried by the courts. However, after the decision of the Supreme Court in the 2013 Norland case, it is clear that the adjustment according to section 13-1(3) is a so-called 'free discretionary assessment', which means that the tax authorities' adjustment can only be tried by the courts to the extent that it is based on wrong facts, it is arbitrary or highly unreasonable.

In addition, the substance-over-form principle is a general and important non-statutory principle in Norwegian tax law.

The starting point in Norwegian tax law is that transactions in accordance with Norwegian private law are respected. The application of the non-statutory general anti-avoidance rule (GAAR) is dependent on the tax authorities showing that the relevant transaction has little value besides the tax effects and that the main purpose behind the transaction is to reduce Norwegian taxes. Furthermore, the tax benefits gained by the transaction must be contrary to the legislative intent (i.e. the relevant transaction is clearly outside the range of situations the tax rule was meant for).

The objective of the GAAR is to find the underlying reality, so substance prevails over form. (It is important to distinguish between this and so-called pro forma transactions, which are disregarded for tax purposes.)

Other legislation

Effective from tax year 2013, there is thin capitalisation legislation in the General Tax Act section 6-41. Section 6-41 is described under the thin capitalisation section below.

Norway has specific legislation in the Petroleum Tax Act section 4 to deal with the pricing of petroleum for tax purposes. Taxation of income from the sale of crude oil and some LPG products produced on the Norwegian continental shelf is based on a so-called 'norm price', which shall be equivalent to the price at which it could be sold between unrelated parties in a free market (i.e. an arm's-length price). When establishing the norm price, a number of factors shall be taken into account including "the realised and quoted prices for petroleum of the same or a corresponding type with necessary adjustments for quality variations, transport costs, etc. to the North Sea area or other possible markets, delivery time, time allowed for payment and other terms".

The norm price is decided individually for each field by a separate governmental board (Norm Price Board). The taxpayer will be taxed, based on the relevant norm price, irrespective of the actual sales' price. The norm price is used both for internal and external transactions.

The Petroleum Tax Act also has specific thin capitalisation legislation for the petroleum sector in section 3d). This is described under the thin capitalisation section below.

The TAA section 4-12 with regulations was introduced in 2007. This section mostly provides reporting obligations and documentation requirements. However, the Tax Directorate has published guidelines that also include some material guidance of the application of section 13-1 and the arm's-length principle. The section is described in greater detail under the documentation section below.

Court cases and revenue practice

The Supreme Court and the lower courts have made a number of decisions concerning TP. Several of the large TP cases in Norway are related to the petroleum activity on the Norwegian continental shelf. Reference will also be made to current revenue practice.

Bareboat charter rate – pricing methods

Trinc and Trag – Supreme Court (1997)

The Trinc and Trag case is primarily an important decision with respect of tax liability to Norway for a foreign rig owner operating on the Norwegian continental shelf. The case also (particularly in the verdicts from the lower courts) contains interesting elements of TP.

Two foreign companies, Trinc and Trag, were controlled by the same owners. Trinc was the ownership company of a drilling rig, and Trag operated the rig under a bareboat charter. Trag operated the rig on the Norwegian continental shelf and was liable to tax in Norway for that activity. The companies had seemingly not used any specific pricing method, while the tax authorities used a cost-plus (CP) method to set an appropriate bareboat charter rate. The court stated that no significant income reduction was required in order to adjust the income in accordance with the GTA section 13-1. Further, the court stated that the tax authorities were entitled to use the CP method in a situation where it was difficult to find comparable transactions in the market, and that the discretionary elements used by the tax authorities in the cost-plus calculation were acceptable. The taxpayer argued to no avail that the resale price method (RPM) was more appropriate. The historic cost of the rig was used as a basis for the computation. This part of the case was not appealed to the Supreme Court.

Captive insurance issues

There are basically two issues regarding captive insurance. The first question is whether the captive provides real insurance. The second question, if the captive is accepted as providing real insurance, is to what extent the insurance premiums meet the arm's-length standard.

Real insurance

Amoco – Supreme Court (2002)

The question was to what extent Amoco's captive represented real insurance. Through previous Supreme Court decisions (including Dowell Schlumberger 1995) it has been concluded that premiums paid to a captive insurance company will, in principle, be accepted as a deductible for income-tax purposes. However, this is subject to two conditions:

- A formal insurance policy that transfers the risk from the insured to the captive must be in place.
- The captive must have the financial capacity to meet any claims under the insurance policy (i.e. there must be a real transfer of risk).

Regarding the latter, the tax authorities (in this case, the Oil Taxation Office [OTO]) have focused on the exposure ratio (maximum payout for one accident/the captive's equity). In the Amoco case the exposure ratio was more than 100% (i.e. the captive could not even meet one maximum loss).

Contrary to the city court and the Court of Appeals, the Supreme Court concluded that Amoco's captive insurance arrangement qualified as real insurance. The main reason for this was the fact that Amoco Norway had placed its insurance policy in an independent insurance company (fronting arrangement). The fronting insurance company had then reinsured all the risk with the Amoco captive company, and Amoco Corp. had guaranteed coverage from the captive to the fronting insurance company. Based on the fact that the fronting company would be in a position to cover any losses incurred by Amoco Norway, irrespective of the captive's financial position, the Supreme Court concluded that the risk effectively had been shifted from Amoco Norway to the insurer. Therefore, from a Norwegian perspective, this represented a true and valid insurance.

However, it should be noted that the Supreme Court in principle accepted the 'exposure ratio' as a key factor in order to test the captive's financial capability. Therefore, it was also concluded that the Amoco captive in itself "clearly did not qualify as a true and valid insurance company".

Statoil – city court (2000)

The city court's decision of April 2000 (Statoil) treated the issue of so-called 'vertical' insurance. The Appeals Board had decided that insurance premiums paid to a company owned directly by the insured could not be viewed as real insurance, since any cash flow to/from the captive connected with premiums/claims would lead to an exact corresponding increase/decrease of the value of the shares in the captive. Due to the ownership of the shares, the risk still remained in the insured company. The city court ruled that there was no legal base for taking the value of the shares of the captive company into consideration when treating the question of real insurance. The case was not appealed.

Captive pricing

Agip – Supreme Court (2001)

The Appeal Board for Petroleum Tax did not accept Agip's insurance premiums as being in line with the arm's-length standard. In order to find the 'correct' arm's-length price, the Appeal Board made use of captive insurance premiums paid by other companies operating on the same petroleum field as comparables. The Appeal Board made the following statement:

"Within captive insurance it is difficult to find comparable rates between independent insurance companies. A comparison with rates paid by other companies on the same or similar fields will be relevant for the evaluation of whether an arm's-length price exists, even if the comparable insurances are with captives. The key point is to thoroughly evaluate the comparability of the policies and to make any required adjustments in order to get a relevant basis for the comparison."

The taxpayer argued that the comparisons and the adjustments made by the Appeal Board were not representative.

The Supreme Court's conclusion was in line with that of the Appeal Board. The Supreme Court referred to the OECD Guidelines and concluded that the Guidelines can and should be used as a supplement to the GTA section 13-1, and that there is no conflict between the two. As the Court found that insurance policies differ significantly from field to field, it was deemed acceptable to use other captive insurances (i.e. controlled transactions) on the same petroleum field as comparables. This part of the decision is in direct conflict with the July 2010 Guidelines section 3.25, which explicitly states that the use of controlled transactions as comparables is not in accordance with the arm's-length principle. There is some uncertainty regarding the solution, but due to the 'lex posterior principle', we believe that section 3.25 prevails over the Agip decision and gives the correct answer *de lege lata* for income years from 2010 and later.

With respect to TP methodology, the Court stated that the OECD Guidelines cover several methods but that none of these methods was directly applicable in this particular case. The Court then stated that in such a situation, the OECD Guidelines must be 'adapted' to the specific situation. Therefore, the Supreme Court accepted that the Appeal Board had determined an arm's-length insurance premium using a combination of several methods as well as its own discretionary judgment.

The Supreme Court also reset the deductible for physical damage from 75,000 United States dollars (USD) to USD 750,000 and consequently denied deduction for all premiums paid for this layer. The Court's reason for this was that a deductible of USD 75,000 was not available in the market. Even if the Court did not explicitly state it, this is the first example of a so-called restructuring of the controlled transaction (*cf. the 2010-TP Guidelines 1.65*), accepted by a Norwegian court.

Fina – Appeals Court (2003)

The Fina case treated two important pricing issues. The first issue was related to the price effect of aggregating and coordinating the group's insurance policies. The captive Brittany was in its external policy given a group discount of approximately 5–10% when insuring the policies of all the companies in the group externally. The discount was due to a reduction in risk (geographical spread and increased volume). This group discount was not passed on to Fina. The company argued that the price of the insurance policy should be set at a standalone level, e.g. without the group discount. The Appeals Court ruled that the daughter companies in an independent relationship through coordinated negotiations could have achieved the group discount, and consequently that the group discount had to be passed on from the captive to the insured companies.

The second issue related to the choice of pricing method. The company argued that the comparable uncontrolled price (CUP) method was the most applicable, and used external comparables originating from other companies and other fields on the Norwegian continental shelf. In some years, the company also had a 5% external insurance in Storebrand. The Appeals Court ruled that the CP method was more applicable, because the use of this method, in total implied fewer corrections and less complicated corrections. The Court also ruled that the 5% insurance was too small to give an indication of 100% of the insurance, e.g. a so-called 'tower'.

Statoil and Hydro Appeals Court cases – OIL (2007 and 2012)
In addition to special issues related to membership in the branch captive Oil insurance Insurance Limited (OIL), the decisions treat issues related to choice of pricing method, and towers. In the Hydro case of 2007, Hydro was insured in the group captive *Industriforsikring* (IF). In one year (2002), Hydro was insured 65% in the captive, and 35% externally in the market. The captive was reinsured in the branch captive OIL, and externally in the market, and retained some layers for its own risk. The Appeals Court ruled that the insurance in OIL was a favourable insurance cheaper than the market, and that the advantage of insurance in OIL belonged to Hydro and not to IF. Since the CUP method did not pass on the 'OIL-advantage' to Hydro, the CP method was more applicable than the CUP method. Even in the year in which Hydro had a 35% placement in the market, the Appeals Court ruled that the CP method was more applicable due to the OIL-advantage. The decision was followed up in a 2012 Appeals Court decision for Statoil. The Appeals Court maintained that OIL was a favourable insurance, cheaper than market prices, and that the 'OIL-advantage' belonged to the insured company (Statoil). Therefore, the CP method was the most applicable method.

Agip – city court – Profit commission I and II (2004/2007)
Both decisions treated a good performance discount called 'profit commission', provided by external insurers to the captive. If the captive had no incidents/claims, the external insurers provided the captive with a bonus corresponding with the 'good performance' level. This performance bonus was not forwarded from the captive to the insured group companies, but to another group company, which acted as an intermediate/coordinator, but had no risk related to the insurance policies. The city court in both cases ruled that the good performance bonus in an independent relationship would have belonged to the insured and not the intermediate/coordinator. None of the decisions were appealed.

Newer Oil Taxation Office cost-plus practice
Except for the Agip case, the Oil Taxation Office (OTO) has consequently used a modified CP method, a methodology which through the Fina, Statoil and Hydro cases has been accepted by the courts. The OTO methodology uses the captive's reinsurance as cost in the CP method analysis. A difficult issue in the use of this method has therefore always been the pricing of risks retained by the captive, typically in the lower layers of insurance, which are often retained by the captive. For captive retention layers in which there is no reinsurance, an estimated cost needs to be found. In the Statoil and Hydro cases, offers, brokers or expert witnesses' estimates were used as cost estimates. In later unpublished decisions, the OTO and the Appeals Board have used statistical methods on historical losses to construct a market price for these layers. This practice can be illustrated by the following table:

Layer	Cost in cost plus
Reinsured layers	Captives reinsurance
Lower layers retained by the captive	Average historical losses (company's or NCS)

The 'plus' element in the CP method has been set to 1%, 2% or 5%, using the profit of a 'fronting company' as a comparable. As a fronting company retains no risk, but gets a profit out of administration services, this is highly questionable, but has been accepted by the courts in the three aforementioned cases.

Financing of subsidiaries – thin capitalisation

In the 1990s, several cases regarding Norwegian parent companies' financing of foreign subsidiaries were decided upon. The key issue was to what extent the Norwegian parent company and lender should charge interest on formal loans granted to foreign subsidiaries, or whether the loans could be deemed as equity.

The first question is whether the capital injection represents a loan or equity. Based on a Ministry of Finance position from 1995 and the result from the court cases, the taxpayer's actual treatment in the statutory accounts will be an important factor – even if it is not entirely decisive.

If it is established that the capital injection in reality represents a loan, the next question is whether (and to what extent) the foreign subsidiary would have been able to borrow money in the market, based on the subsidiary's actual financial position (i.e. whether the subsidiary has borrowing capacity). To the extent the subsidiary has borrowing capacity, the Norwegian parent company will have to include interest income from the foreign subsidiary in its tax accounts.

The petroleum sector

There exists extensive administrative practice from the OTO on the thin capitalisation issue. The practice of the OTO and the Appeals Board in the 1990s are described in an article by Director Torstein Fløystad in the periodical 'Revisjon & Regnskap' 1990 nr. 2 and 3). According to Fløystad, approximately 9.3 billion Norwegian kroner (NOK) were reclassified from debt to equity with base in the arm's-length standard, in approximately 30 decisions. As a rule of thumb, the following equity requirements had to be met for exploration and development activities:

Exploration	Development
100% equity	20% equity

There were no thin cap decisions for companies with production activities (which generated cash flow). The equity requirements were based on a 'dynamical cash flow analysis', based on a comparison of the cash flow from financing activities versus the cash flow from opex and capex through the year, and not on a fixed equity percentage on a fixed point in time (e.g. the balance sheet 31/12 or 1/1). Three of the cases (BP, Amerada and Amoco) ended up in the courts – all of them were won by the State.

In a Supreme Court case from 2007 (Statoil Angola), the 20% requirement for development companies was a central undisputed premise that both parties and the Court agreed upon. Statoil Angola Block 17 AS was a Norwegian limited liability company with a permanent establishment (PE) in Angola. The company was in 2000–2001 in the development phase, and consequently needed to meet the 20% equity requirement set forth by the Appeals Board's guidelines. The company had inter-company loans both from Statoil ASA resident in Norway, and Statoil Coordination centre resident in Belgium. The loan from Statoil ASA was priced at 0% interest. The company's reasoning for setting the interest rate to 0% was that the loan for tax purposes was a substitute for equity, due to limited borrowing capacity of 80%. The Appeals Board ruled that the borrowing capacity needed to be distributed proportionally between the loan with Statoil Coordination Centre and the loan with Statoil ASA, according to the size of the loans. The Appeals Board's decision was upheld by the city and the Appeals Court, but the Supreme Court 3-2 ruled that there was not sufficient legal basis for distributing the borrowing capacity.

The 20% requirement for development activities is probably still valid today in the onshore tax regime, whereas the 100% requirement for exploration has changed to approximately 30%, due to new legislation for refund of the tax value of exploration activities in the PTA section 3 c).

In 1992, this practice was followed up with new legislation through thin cap rules in the PTA section 3 d) and 3 h). The legislation has been revised several times, until it reached its current form in section 3 d) in 2007.

According to the current section 3 d), interest will be deductible either in the offshore 78% regime, or the onshore 27% regime. Section 3 d) differentiates between 'interest on debt' and other financial items. Other financial items (outgoing loans, hedging, financial instruments, etc.) are only deductible/taxable in the 27% regime. The definition of 'interest on debt' includes currency gains/losses related to the debt. It includes interest on both internal and external loans. It is somewhat unclear if the definition includes guarantees.

Deductible interest is allocated to the offshore 78% regime according to the following formula:

$$\frac{\text{Tax value of assets * 50\%}}{\text{Interest bearing debt}}$$

There are definitions of 'tax value of assets' and 'debt' in the formula, in section 3 d). The tax value of assets is usually much lower than book values, due to favourable tax depreciations of 1/6 per year for offshore assets. The values per 31/12 are used for tax assets, whereas the debt is calculated as the average debt through the year on a daily level. The definition of 'tax value of assets' includes most offshore assets (pipelines, wells, production facilities) and some onshore assets (buildings, office equipment, etc.). The definition of 'debt' includes most types of debts on loans, with some important exceptions. For instance, supplier debt and short-term debt generated within the licence agreement is not included.

The following example illustrates how financial items are treated according to section 3 d):

Internal interest	-50
External interest	-50
Agio/disagio	10
Net interest	-90

Tax value of assets	100
Debt	150
Allocation key offshore	0.33
Deductible offshore (78%)	-30
Deductible onshore (27%)	-60

The net interest of -90 is allocated offshore/onshore using the 0.33%/0.66% allocation key.

The most notable feature of the section 3d) model is that you need assets with tax value to get interest allocated to the offshore 78% regime. Since most exploration companies have very low-tax value of assets, they get most of their interest deductible, only in the 27% regime.

Section 3 d) is thin capitalisation legislation for the offshore regime. Consequently, there can be no other correction for thin capitalisation in addition to section 3 d) for interest allocated offshore. The general thin capitalisation rule in section 6-41 of the GTA does not apply to upstream companies, so the general arm's-length provision in section 13-1 can in theory be used to censor interest deductions allocated onshore (27%) in thinly capitalised upstream companies. However, there have been very few cases where the tax authorities have actually argued for an onshore thin capitalisation correction.

Thin capitalisation cases outside the petroleum sector
Outside the petroleum sector, the Scribona case from 2007 is the only example of a thin capitalisation decision to have reached the courts. The company had a negative equity of approximately NOK 80 million. The company funded its opex, and the purchase of another company exclusively with debt of approximately NOK 480 million. When the tax authorities computed how much of the interest deduction should be denied, they based their computation on an equity ratio of 15% of the total capital in the company. This was accepted by the court. In addition, the court confirmed the general view that a thin capitalisation evaluation has to be based on several elements and that the crucial question is whether an independent lender (normally a bank) would have been willing to finance the taxpayer under the current circumstances. The court ruled that Scribona in an independent relationship would have needed at least equity from its owners.

The Norwegian Company Act has certain requirements regarding the equity level of a company, even if this has no direct relevance for tax.

The Norwegian tax authorities have challenged the capital structure in several leveraged buyout transactions performed by private equity investors over the last few years. As part of the financing of the buyouts, the investors used equity and a shareholder loan in addition to loan financing from third parties. In several tax audits the authorities have claimed that there is no remaining loan capacity beyond the loan financing from third parties. As such, the authorities have not accepted interest on shareholder loans as tax-deductible. Some of these cases have been subject to settlements with the authorities during the audit process.

In 2010, the Norwegian Supreme Court ruled in the Telecomputing case. The Norwegian company Telecomputing had provided loans to a US subsidiary. The subsidiary had paid interest on the portion of the loans that was considered to be within the subsidiary's borrowing capacity. The part of the loan exceeding this borrowing capacity did not yield any interest. Later, the entire loan was converted to equity, triggering a loss for the parent company. The parent company claimed tax deduction on the entire difference between the nominal value of the loan and the assumed fair market value of the shares. The tax authorities claimed that the portion of the loan exceeding the borrowing capacity should be characterised as equity and that the deduction for the equity portion should be denied. The Supreme Court ruled in favour of Telecomputing, accepting that the total amount was to be characterised as a loan. Based on the Supreme Court ruling, the characterisation of nominal loan amounts will have to be based on an assessment of whether the loans – or the portion of the loans – predominantly resemble a loan arrangement or an equity arrangement. Lack of borrowing capacity for the borrower will not necessarily imply that the provided funds should be characterised as equity.

Equity requirements/thin capitalisation rules in the General Tax Act (GTA)
With effect from tax year 2013, new equity requirements for all companies were introduced in the GTA section 6-41. According to the section, deductible internal interest cannot exceed 30% of taxable EBITDA. The main features are:

- Rule application threshold is NOK 5 million. If exceeded, the rules will apply to the full amount.
- Interest limitation threshold is 30% of taxable EBITDA.
- Interest that cannot be deducted according to the section in a tax year, can be carried forward. The carry-forward period is ten years.
- External interest costs are generally excluded, but will consume the available frame for the deduction for internal interest.
- Some external loans will be considered as internal loans, e.g. loans secured with guarantees from a related-party. Comfort letters may also be deemed as a guarantee.
- Capping of interest deductions may entail payable tax, despite available tax losses carried forward in the company or the within the tax group.

Section 6-41 does not apply to petroleum companies, due to the special rules in the PTA section 3d). The rules do not apply to financial institutions like banks.

It should be noted that even if interest is non-deductible according to section 6-41, the GTA section 13-1 is still applicable for the remaining interest deduction.

Loan pricing cases

All TP court cases regarding loans except one (Lyse Energy) arise from the work of the Oil Taxation Office. The Appeals Board for Oil Taxation has decided in approximately 30 cases, of which five have reached the courts. Two of the decisions are very old, but still have some relevance. There are three cases from the period 2008–2014, of which two – Bayerngas and Exon – are recent decisions and illustrate well the current approach of the Oil Taxation authorities. The last case is a special case arising from the Central Tax Office for Large Enterprises.

There is also extensive unpublished revenue practice from other tax offices.

Texas Eastern city court (1989)

The case treated Texas Eastern's interest deductions for intragroup loans for 1982. Texas Eastern had applied an interest rate of 'Prime rate + 1%'". Prime rate, at the time, was an American interbank reference rate. The company had based this rate on an offer from an external bank in 1983, based on a premise of Texas Eastern as a standalone company. The tax authorities, based on a comparison between Texas Eastern's loans and two other oil companies' external loans (NOCO and Amerada), set the margin to prime rate plus 0%. The tax authority's rate was based on a premise of Texas Eastern as a member of the group. This led to an income increase of NOK 12 million for the income year 1982.

The court ruled that the interest for Texas Eastern should be set as a member of the Conoco Group. The same now also follows from the TP Guidelines Article 7.13. The court also ruled that the offer from the external bank was not relevant, since it concerned 1983 and not 1982, and as it was not an actual transaction. The court agreed with the tax authorities that the best comparisons were the external loans with Amerada and Noco. The company argued to no avail that these loans were not comparable because Amerada and NOCO had better credit ratings, and that the external loans were different from the internal loans in many of their features. The case was not appealed.

Conoco Appeals Court (1992)

Conoco had several intragroup loans of London Interbank Offered Rate (LIBOR) + 1% with affiliated companies. The tax authorities set the arm's-length interest rate to LIBOR + 3/8%, which implied an income increase of NOK 66 million for the years 1982–85. The authorities used both intragroup loans and external loans for other oil companies (Exxon, Shell and Mobile) as comparables. The company had referred to an offer it had received from Citibank of LIBOR + 7/8%(which had not resulted in a transaction), and also to the assessments of several expert witnesses.

The first issue was whether the Norwegian company should be treated on a standalone basis, or as a member of the Conoco group. The Court ruled that the interest for Conoco should be set as a member of the Conoco group. The same now also follows from the TP Guidelines Article 7.13.

The second issue was choice of comparables. The tax authorities had used external and internal loans for other oil companies on the Norwegian continental shelf (Exxon, Mobile and Shell) as comparables, as all of these companies had a share in the important Statfjord field. The company had argued that all of these companies had a better credit rating than Conoco, but the Court ruled that there were no substantial differences between the four companies, and that these loans consequently were good comparables. The Court disregarded the offer from Citibank as an 'uncompleted transaction'. The Court entitled little or no significance to the expert assessments. The case was appealed, but dismissed by the Supreme Court.

Lyse Energy Appeals Court (2009)
Lyse Energy AS (LEAS) was owned by 16 Norwegian municipalities. LEAS was funded by a subordinated loan of NOK 3 billion, with a maturity of 60 years and an interest rate of the Norwegian Interbank Offered Rate (NIBOR) + 2%. The tax authorities argued that a subordinated loan with a maturity of 60 years could not be found in the market, and that no rational party would fund itself in this way, because maturity of this time length would be extremely expensive. The Court stated that a restructuring of the maturity of a loan was a restructuring according to Article 1.37 of the 1995 TP Guidelines (now Article 1.65 in the 2010 TP Guidelines). The Court ruled that the tax authorities had not proved that a maturity of 60 years was 'irrational' in the sense of Article 1.37. The Court also observed that 20 years existed in the market, and that these had a higher interest rate than the 2% margin achieved by LEAS. Based on this the Court ruled that there was no reduction of income. The case was appealed by the State, but dismissed by the Supreme Court.

Cash pooling/group account system (2010)
The January 2010 Appellate Court decision in the ConocoPhillips cash pool case provides an indication as to how far Norwegian tax authorities (in this case the Oil Taxation authorities) are prepared to stretch the theory of the arm's-length principle in practice:

Two Norwegian ConocoPhillips companies (in the following jointly referred to as ConocoPhillips Norway) were party to a cash pool arrangement. ConocoPhillips Norway had several accounts in different currencies. The sum of all these accounts constituted ConocoPhillips Norway's net position in the group's cash pool. More than 150 other group companies participated in the cash pool arrangement, and the total of the net positions of all companies constituted a so-called top account, which was placed in the Bank of America. ConocoPhillips Norway was consistently in a net deposit position. Although ConocoPhillips Norway was able to document that an alternative stand-alone relationship with an external bank would have yielded a lower interest income on the Norwegian companies' deposits, the Court of Appeals ruled that in an arm's-length set-up, an independent party in ConocoPhillips Norway's (net deposit) position would have received a larger part of the overall benefit of the cash pool arrangement. As a result, a higher interest rate was applied to ConocoPhillips Norway's net deposits for tax purposes, increasing the companies' taxable interest income to Norway. A key element in the Appellate Court's decision is the theoretical maxim that the arm's-length test shall be conducted by comparing the actual transaction to an otherwise identical transaction in which one imagines that there is no community of interest. The decision is controversial, especially because – as ConocoPhillips Norway unsuccessfully argued – independent parties never enter into such cash pool arrangements. The validity of the Oil Taxation authorities' (and the Court's) arm's-length test is, therefore, questionable. However, the case was not admitted to the Norwegian Supreme Court and the Court of Appeals' decision is legally binding.

Norway

Bayerngas Norge AS (2012)
In the Bayerngas Norge AS case from March 2012 the lower court considered whether the interest margin on two intragroup loans were arm's length. The credit rating was a key factor. The court concluded that in the specific case it would be correct to base the rating on the companies standalone credit profile (SACP) and to 'notch' this up, based on the group affiliation rather than to 'notch' down the parent company credit rating. The key question for the court was to what extent implicit parent company guarantees from the parent company impacts the credit rating. The court considers and determines the implicit support based on the specific fact pattern in the case. Certain factors are emphasised: Strategic importance, percentage of ownership, management's control, plans and attitudes, shared name, jurisdiction, mutual sources of capital, potential risk, and history – support in other cases, parent company's capacity to provide support, ratio between investment and debt in subsidiary, and other owners. In the decision the court concludes that the standalone credit rating for the specific borrower could (at the best) be notched up four notches because of the implicit support. The judgment was not appealed and is legally binding. The decision is thorough and should be taken into consideration when assessing the credit rating of a Norwegian subsidiary.

Exxon city court (2014)
The decision treats the pricing effects of maturity, and involves a restructuring of the transaction with reference to the substance-over-form criteria in the TP Guidelines Article 1.65.

ExxonMobil Exploration and Production Norway AS (EEPNAS), and ExxonMobil Production Norway Inc. (EPNI) are both members of the Exxon group, the world's largest oil company. In 2005, the two companies established a combined deposit and withdrawal facility with the Dutch resident company ExxonMobil Capital NV (ECNV) as lender. The interest rate was 'average bid' Norwegian Interbank Deposit Rate (NIDR) – 0.0625%. The interest rate is an 'overnight rate', i.e. an interbank for deposit rate for maturities of one day. The NIDR is published both for ask and bid. The 0.0625 deduction was ECNV's margin/profit.

In 2005 and 2006 the companies had large average positive deposits, with an average maturity of six months. The deposits followed a pattern in which the deposits gradually increased, corresponding with the cash flow from oil and gas sales, and then dropped significantly each quarter at the payment of the 78% offshore tax. Even at the time of payments of taxes there were large positive deposits.

The OTO argued that there was an income reduction due to the fact that the deposits' actual maturity was much longer than overnight. The tax authorities argued that the substance-over-form exception in the OECD TP Guidelines Article 1.65 was applicable, and that the arm's-length transaction was to use an interest rate of six percent. The tax authorities also argued that the company in an independent relationship would have achieved the average of the bid and ask notation of the six months' NIDR. The Appeals Board concluded in accordance with the OTO's argumentation. This resulted in an income increase of a total of NOK 122 million.

The court upheld the tax authority's decision, accepting the arguments of the tax authorities.

OTO practice – general

The Bayerngas case, mentioned above, is a good illustration of the OTO's current practice on intragroup loans. The principal method is the CUP method. This is often the case for exploration companies, but less common for production companies. If there are no comparables available, the OTO uses the rating methodology of Standard & Poor's or Moody's to establish a standalone credit rating for the company. Thereafter, an assessment of the effect of group affiliation is done, usually resulting in notching the company upwards (a higher credit rating). The last step is to find comparable loans for a company with the same credit rating at the date of the transaction. This is usually done using data from Thomson Reuters or Moody's Investors Service (the OTO subscribes to at least one of the rating agencies' services).

Intragroup charges

In total, there are five cases regarding intragroup services that have been decided upon by Norwegian courts. The cases are heavily dependent on the specific circumstances and facts of each case and not homogenous; however, it is fair to say that the different city and appeals courts have had very diverging views on the arm's-length standard, especially regarding documentation requirements. In total, three cases have ended up in the tax authorities' favour, while the taxpayers have won two cases.

There also exist approximately 20 decisions on intragroup services from the Appeals Board for Oil Taxation, of which 10–11 have been published.

The 3M case (2002)

In 2002, the Court of Appeals decided in the '3M case' on the tax deductibility of charges for inter-company services. The decision was appealed, but the Supreme Court dismissed it.

3M had for several years charged its local sales' companies, including the Norwegian sales company, a licence fee for various inter-company services and use of trademarks. The licence fees ranged from 2% to 5% of actual turnover in each single sales' company.

The Norwegian tax authorities disallowed the deduction for the licence fees, as 3M Norway AS was deemed not to have provided sufficient documentation for services received. The tax authorities also charged 3M Norway a penalty tax, as they were of the opinion that the company had not provided sufficient information.

However, the city court, as well as the Appellate Court, concluded that the licence fee was in line with the arm's-length principle. The court stated that as long as the OECD Guidelines accepted the indirect method for inter-company charges, it would also have to be accepted that detailed documentation could not always be given. In this particular case, the 3M group's accounting system was not designed to give a detailed breakdown/documentation for the various types of inter-company charges. The court further concluded that there was no doubt that the Norwegian subsidiary had received a number of significant services, and given the fact that the Norwegian subsidiary had shown good financial results over several years, it was assumed that a third party also would have been willing to pay the same level of licence fee.

Intrum Justitia (2008)
In 2008, the city court of Oslo decided in the Intrum Justitia case on the tax deductibility of charges for the use of intragroup computer programs. The Intrum Justitia Group is a Swedish group providing credit management services worldwide. The Norwegian company Intrum Justitia AS sold a computer program to a group company in the Dutch Antilles for NOK 3.3 million and then paid a royalty for the use of the program. The group company was responsible for all computer systems in the group, and made an upgrade on the program of approximately NOK 2.2 million. The group also had general development costs of computer programs of approximately NOK 250 million. The Norwegian company then paid a royalty of NOK 40 per credit case for use of all the centralised computer programs. In total, the royalty amounted to NOK 10 million per year. However, the Norwegian company used only the parts of the program that already existed before the upgrade, and used none of the other centralised computer programs. Other members of the group in Germany and the UK paid lower royalty than the Norwegian company, due to their use of only local software.

As the company could not document that the centralised programs and development cost had been of benefit for the Norwegian business, the court ruled that an independent party would not have paid a royalty for programs it did not use. The court also emphasised that group companies in the UK/Germany were allowed to use their local software and paid lower royalties, and that the fee of NOK 10 million per year was high compared to the sales price of the computer program of NOK 2.2 million. The decision was not appealed.

Enterprise Oil (2010)
In 2010, the Court of Appeals concluded that the Enterprise Oil Norge AS did not provide sufficient TP documentation to document a tax deduction for intragroup services provided by the foreign parent company. The parent company did not perform other operations than services to its subsidiaries. The Court of Appeals rejected Enterprise Oil Norge AS's tax deductions of NOK 141 million. With respect to the documentation requirements, the Court of Appeals stated: "The documentation requirements must depend on the actual circumstances of the situation, especially the reason why it may be necessary with further information. The OECD Guidelines should not be understood in a way that estimates, valuations or examples of services are sufficient to fulfill the documentation requirements." This part of the decision is in direct conflict with the 3M case. It should be noted that the calculation method for the costs related to the intragroup services was complicated. The court further emphasised that the company had not in a sufficient manner documented which activities were performed. The uncertainty that therefore was created was used against the taxpayer. The company had used the CP method, with a 5% mark-up. The tax authorities used the CUP method, comparing the company's price per hour with the hourly prices of independent service providers, using mostly secret comparables. The court ruled that the CUP method was the most appropriate method, and also ruled that the tax authorities' use of secret comparables was not in conflict with the arm's-length principle. The Norwegian Supreme Court did not admit the case, and the decision in the Court of Appeals is legally binding.

Scientific Drilling (2010)
The documentation issue was also treated in another issue in 2010, that of Scientific Drilling. Scientific Drilling was a British company providing services to oil companies on the Norwegian continental shelf. In providing the services, the company used equipment developed, produced and owned by a sister company in the UK, for which it paid rent. The company also paid for research and development (R&D) services from the same company. The tax authorities claimed that an independent would not both pay rent for the equipment and at the same time pay for R&D services for the same equipment. The court ruled that a 'mere suspicion' that the costs were charged twice was not enough to prove a reduction of income. The court also emphasised that the tax authorities had not specified what documentation requirements were necessary.

Total E&P (2014)
In June 2014, the city court made its decision in the Total case. The case will most probably be appealed.

The French company Total SA (TOTSA) France provided several management and administrative services to the Norwegian company Total E&P Norge (TEPN). The service fee was set using allocation keys according to the OECD Guidelines Article 7.23. In total, TEPN had paid NOK 617.3 million for the services over the period 2003–2008. The tax authorities ruled that the services were not sufficiently documented, and had allowed a deduction of NOK 275 million, consequently there was an income increase of NOK 342 million. TEPN had admitted an over-allocation of NOK 72 million over the period, due to non-compliance with the group's allocation keys, but argued that the authorities had used a wrong documentation standard, and that the services were sufficiently documented. The company had provided witnesses and much new documentation for the court that had not been provided to the tax authorities.

The court stated that the indirect allocations method by its nature implies that the documentation standard cannot be the same, or as high, as for direct allocations. Due to the need for audit control, it can however not be sufficient to generally state what services the service provider's offer, the allocation key used and costs incurred for the services. In order to claim a deduction for indirect services where the remuneration is based on an allocation key, the company also needs to give examples of services, and estimates, in addition to the general descriptions of services provided, in order to get a deduction. The court also stated that the documentation standard could vary, depending on the type of service and what documentation is practically possible to provide. It stated, as an example, that the documentation standard could be higher for law services than for R&D services.

In Norway, there is a general rule, based on court practice, stating that the courts cannot take into consideration new documentation that the taxpayer has been asked to give, or had good reason to give unasked, to the tax authorities during the audit or the appeals' process. Based on a concrete judgment, the court ruled that even though the company had given sufficient documentation to the court, it had not given sufficient documentation to the tax authorities during the appeals' process. Consequently, the court upheld the appeals board's decision. In recent tax audits, especially following the introduction of the specific TP documentation requirements, the Norwegian tax authorities tend to demand that a Norwegian service recipient documents its benefit from inter-company services in quite extensive detail.

Real estate lease cases
Due to the gap between the 78% offshore tax, and the 28% (now 27%) onshore tax, there have been many cases in which the price of real estate lease has been assessed versus the arm's-length standard. The oil companies typically own their real estate in a single purpose onshore company, which leases the offices to the offshore company, giving incitements to set the lease as high as possible. Three of these cases have ended up in the courts. While this specific TP field probably has little relevance outside Norway, the decisions include some general TP aspects that may be of general relevance.

Tananger case I and II (2007 and 2013)
In 2007, the Appeals Court treated the Tananger base case. The Tananger base is the supply base for Norway's largest oilfield Ekofisk, owned by the Ekofisk Group (ConocoPhillips, Total, Statoil and others). The Ekofisk group sold the base to an external party in a 'sale-leaseback transaction'. The sale price was taxed in the 28% onshore regime, whereas the lease was deductible for the offshore company in the 78% regime. The lease price was a central premise for the sales' price, as the sales' price for the real estate was set to the net present value of future lease income. The lease price was set to approximately NOK 1,900 per square metre office space, whereas the market price at the time in Stavanger was approximately NOK 1,000 per square metre. As they got the NOK 900 back through the sales price (exchange of cash flows), and used a reasonable discount rate, it did not matter to the Ekofisk group that they had to pay more than the market price to an external party. The Appeals Court ruled that section 13-1 of the GTA was applicable, and that the transaction could be regarded as an internal transaction due to the interest in saved taxes. As there was no doubt that the lease price was far above the market price, there was also a reduction of income. This was a different legal angle compared to the tax authorities' approach, which had regarded the NOK 900 per square metre over the market price as having no connection with income in the offshore income (a cost incurred to get the purchase price of the real estate), and so not deductible in offshore income according to the GTA section 6-1. The case was appealed, but the Supreme Court dismissed it.

In 2013, the Appeals Court treated a continuation of the first Tananger-base decision (for income years after the first case). The case was won by ConocoPhillips.

ConocoPhillips Tangen 7 (2013)
The case is regarding the lease of Norske Conoco AS's (Conoco) main office in Norway – Tangen 7 in Dusavika (Stavanger). The building included approximately 13,000 square metres of office space. Conoco had leased the building from its subsidiary Conoco Investments AS (CIN) since 1991 with a ten-year lease period. The lease was deductible for Conoco in the 78% tax regime, and taxed by CIN in the 28% onshore regime. The old contract expired in December 2000, but a new ten-year contract was not entered into before February 2001. In the new contract Conoco leased only 85% of the office space due to manpower reductions, whereas approximately 50% of the office space was actually used. In January 2000, 1,500 square metres were leased to Randaberg commune at NOK 1,400 per square metre for one year. Conoco also made offers to several independent parties to lease the offices, ranging from NOK 800 to NOK 1,500 per square metre. Conoco's neighbour, Total, had an external contract at NOK 1,200 per square metre. The new internal lease price was 'barehouse', and set at NOK 1,450 per square metre.

In 2002, Conoco merged with Phillips and in September 2003 it was decided to use Phillips' headquarters in Tananger, and to sell Tangen 7. The offices were empty from October 2002 to May 2005. In 2005, the building was sold to Havanacci AS and at the same time a new 15-year lease contract was entered into with Stolt Offshore AS at NOK 1,100 per square metre. Stolt Offshore AS was granted a relief from the lease the first two years of the contract, effectively making the lease price at approximately 800 per square metre. Based on published market statistics, there was a general increase in the market prices for office leases in Stavanger in the period July 2000–January 2001 of approximately 10%, and an increase from 2001 to 2005 of approximately 20%.

The tax authorities argued that the time of transaction should be set at July 2000, since a rational independent party would not renegotiate the contract of their office less than half a year before the contract expired. The court ruled that this would be a restructuring of the actual transaction, not in accordance with the arm's-length principle (*see TP Guidelines section 1.65*). The tax authorities argued that the Stolt Offshore contract was a perfect CUP comparable, except for the difference in time, and that it was possible to use market statistics backwards to make reasonable accurate correction for the difference in time. The Appeals Court ruled that use of a comparable that came four years after the year of the transaction was in hindsight not in accordance with the arm's-length principle. The tax authorities also argued that the contract with Randaberg municipality and offers to external companies were good comparables, implying a reduction of income. The court ruled that the difference of a one-year contract for a small part of the building was not comparable with a ten-year contract, and that offers could not be used as transactions in the CUP method. Instead, the court ruled that the comparison with the external comparable of Total (and some other oil companies offices) was the best comparable, and that this comparison showed that there was no reduction of income.

Sale of petroleum products

The sale of petroleum products is divided into three types of products: oil, NGL (natural gas liquids) and dry gas (methane). These products are treated differently regarding TP regulations.

Oil

Sale of oil is regulated by the norm prices set by the Petroleum Price Board, described above.

NGL

NGL (natural gas liquids) consists of the petroleum products butane, ethane, propane, isobutene, naphtha and condensates. Another commonly used term is LPG (liquid petroleum gas).

Unlike oil, the sale of all LPG had until 2012 always been regulated by the ordinary TP regulations in the GTA section 13-1. NGL is usually considered a side-product of oil and gas production with less value; however, some 10% of all the sales of petroleum products were NGLs. From 2012, some NGL sales (sale of propane and isobutene from Kåstø) have been covered by norm prices, whereas the rest is still covered by the ordinary TP regulations.

There are several Appeals Board decisions from the 1980s and the 1990s covering intragroup sales of NGL. All decisions used the resale minus method, and set the resale margin to 2.5%. None of these decisions were brought to court.

In most decisions in the period of 2005–2014, the Appeals Board switched to the CUP method. The Appeals Board has stated that it still considers the resale minus method the most appropriate, but that due to the lack of information of the resale prices from the oil companies, it has used the CUP method. In later years, the OTO has systematically collected all external and internal contracts of NGL on the Norwegian continental shelf, and makes use of this information when using the CUP method. This highlights the issue of 'secret comparables'. A very good illustration of the OTO/ Appeals Board practice can be seen in the Total case (*see below*).

Total LPG case (2014)
The case is regarding Total E&P Norge AS (TEPN) intragroup sale to its sister company TOTSA for the years 2002–2007. TEPN sold its NGL FOB (free on board). The price was set to the NGL index Argus CIF ARA Large cargoes, published by the price bureau Argus. As this index is based on CIF sales, a correction for freight deduction was needed to set the internal price correctly. To correct for freight, Total used a freight rate published by Poten & Partners for spot rates. TEPN was asked by the tax authorities to provide the tax authorities with TOTSA's resale prices, but were not willing or able to do this.

The tax authorities compared Total's sales with the sales of other companies, starting with all sales of the NCS, then limiting the search for external comparable contracts based on the following criteria:

- cargo size (only sizes similar to total ships were chosen)
- terminal (only Kårstø and Teeside)
- sale of total production vs. sale of limited part of production
- freight (CIF/FOB)
- duration of contract (Total's contract with TOTSA was long-term)
- volume (only volumes similar to TEPN's volumes were selected)
- demurrage.

All contracts not similar were excluded, e.g. the tax authorities did not try to correct for differences in the excluded contracts. Based on this, 2% of total sales of the NCS remained as comparables. This comparison showed a difference of USD 8–15 per tonne in TEPN's disfavour. In court, the tax authorities also showed comparisons of the spot freight rates used by TEPN with long-term freight rates, which were much lower. The tax authorities argued that long-term freight rates were much more appropriate, as TOTSA's freight rates were long-term.

TEPN argued that it had not had access to the comparables, and that this was a use of secret comparables not in accordance with the arm's-length principle. Total also argued that the result of differences should not have been that the contracts were excluded, but rather that they should have made corrections for the differences.

The Appeals Court found that a long-term freight rate was most appropriate, and consequently that Total's freight deduction was too high. The Court also ruled that the tax authorities' selection criteria and use of them was in accordance with the arm's-length principle, and that the comparison with external contracts showed a reduction of income. The Court also found that the tax authorities' use of secret comparables was in accordance with OECD papers, the arm's-length principle in the TP Guidelines and Norwegian tax assessment law. The Court emphasised that TEPN/ TOTSA had been unwilling to provide the resale prices, that TEPN had full insight

into the tax authorities' selection process and that the contracts had been presented to TEPN in an anonymised form as far as the OTO's confidentiality obligations allowed. The case was appealed. Only the part of the decision related to secret comparables was allowed to be tried by the Supreme Court. This part of the decision was to be tried in October 2014.

Dry gas

Dry gas (methane) is Norway's second largest export product (after oil), and was expected to pass oil in volumes sold (but not in revenues) in 2014. Dry gas was until 2002 sold externally through a sales organisation called '*Gassforhandlingsutvalget* (the Gas Negotiation Committee)', in which the three largest producers (Statoil, Hydro and Total) negotiated on behalf of all the gas producers on the NCS with the continental and British buyers. In 2002, the EU claimed that this was a monopoly in conflict with Norway's obligations under the EEC Treaty. Norway complied with the EU claim, and so from 2002 onwards, each company has sold its own equity gas separately. This has opened up for internal sales, and the percentage of inter-company sales has risen steadily since 2002.

Generally, dry gas TP is extremely complicated and requires knowledge of the gas markets, transport systems, gas contracts and gas pricing mechanisms. The TP of dry gas is a focus area for the OTO, and from 2012 onwards, the companies were obliged to report all internal and external sales to the OTO, which acquired an advanced database for handling the information. All internal gas contracts are audited. Due to the complexity and time-consuming nature of gas TP cases, there are still few Appeals Board decisions and no court cases. None of the Appeals Board decisions are published. There have been five APA cases.

Usually, the CUP method is used, using published prices from the liquid European gas hubs (NBP, TTF, NCG, Zeebrugge) as reference prices. A first theme in the Appeals Board cases has been issues connected to the choice of reference price/index (TTF or NCG, etc.), option values due to ability to switch geographical markets and the choice of contract (day ahead, month ahead, system average price – system marginal bid price, etc.). A second main theme has been deductions in the reference price for various costs and risks. A third main theme has been the pricing of volume flexibility. A fourth main theme has been the compliance with internal contracts. Contract clauses regarding nominations of gas volumes, *force majeure*, replacement gas, (liquidated) damages and renegotiation clauses have all been interpreted for tax purposes, and there have been disagreements causing significant income raises.

Business restructurings

Transfer of intellectual property (IP)

In September 2007, the Court of Appeals issued its verdict in the Cytec case. (Cytec's appeal to the Supreme Court was dismissed in January 2008.) Cytec Norge AS (Norway) was originally a fully fledged manufacturer, which was changed into a toll manufacturer in 1999. The customer portfolio, technology, trademarks and goodwill were apparently transferred to the related entity – Cytec Industries Europe (the Netherlands) – free of charge. The Appellate Court found that Cytec Norge AS held IP rights of considerable value prior to the 1999 restructuring, and that the Norwegian entity should have received an arm's-length remuneration for the transfer of these rights to the related Dutch entity. Hence, the Court accepted the Norwegian tax authorities' calculation of such remuneration and the increased income.

Business restructuring – sale of shares
The Oslo District Court ruled in 2009 in the Tandberg ASA case regarding transfer of shares held by a Canadian group entity. The shares were sold to the Norwegian parent company – Tandberg ASA. In connection with the transaction, Tandberg ASA claimed losses for a write-down on a loan to the Canadian entity. The tax authorities challenged the loss, and also increased the taxable income of Tandberg ASA, based on an assumption that the shares had been transferred at a lower than fair market value that represented a taxable dividend.

Although the Court ruled in favour of Tandberg ASA, it is worth noticing the strong criticism by the Court, due to the fact that Tandberg ASA could not present a thorough valuation performed at the time of the transfer. The Court clearly stated that valuations performed at a later time could not be given the same weight as contemporaneous valuations.

Principal models – commissionaire models and limited risk distributors
Dell case (2011)
The Supreme Court delivered its decision on 2 December 2011 in the Dell case. The Irish company – Dell Products Ltd – had a commissionaire agreement with the Norwegian group company – Dell AS. Dell AS marketed and sold Dell products in the Norwegian market in its own name, but for the risk and account of Dell Products Ltd.

The Appellate Court ruled – in line with the district court – that Dell AS was in fact a dependent agent for Dell Products Ltd with reference to Article 5.5 of the Ireland–Norway income tax treaty of 2000. An important question in the case was whether Dell AS had the ‘authority to conclude contracts in the name of’ Dell Products. In the Norwegian version of the tax treaty, the phrase for ‘in the name of’ reads ‘*på vegne av*’, this literally translates to ‘on behalf of’. Based on its own interpretation, the Appellate Court developed its own test in order to conclude whether this was the case. The judgment resulted in some considerable debate and discussion on the international tax arena.

The Supreme Court found, in a very clear and unanimous judgment, that Dell AS, acting as a commissionaire, did not create a PE for the non-resident principal Dell Products. The Supreme Court considered the Vienna Convention (the tax treaty between Norway and Ireland Art. 5 paragraph 5 in Norwegian and English languages), the OECD Model Tax Convention with commentaries and case law with special emphasis of the French Zimmer case from 31 March 2010. The Supreme Court also underlined the fact that similar commissionaire arrangements were accepted by 15 other jurisdictions, among them Sweden, without any questions being raised related to PE for the commissionaire.

The conclusion of the Supreme Court was that the competent authorities in the tax treaty had chosen an arrangement where it is decisive whether the commissionaire legally binds the principal. Another criterion, the Supreme Court added, did not have support in the text of the treaty or in the Model Tax Convention and a different interpretation could create substantial practical and legal technical difficulties. Dell Products won the case and the State had to pay the full costs of the proceedings.

June 2012 (Vingcard)
In the June 2012 Appellate Court decision in the VingCard case, the court recognised the principal model as a business model for tax purposes including limited risk allocation to the US distributor company. The Court pointed out that the US distributor company was left with a limited profit, which reflected the company's role in the transaction, and that it should be possible for group companies to enter into such an agreement. It can be derived from the decision that a TP model that grants guaranteed return to a foreign distributor (return on sales method with a range) as well as true-up payments including year-end adjustments of the income of the distributor, could be accepted from a Norwegian tax perspective. The decision accentuates the importance of intragroup agreements in order to have a legal basis for the risk allocation. The Appellate Court decision is legally binding, as it was not appealed.

Intangibles – share of residual return for non-routine functions return
The September 2011 Oslo City Court decision in the Accenture case relates to deductibility of royalties paid by a Norwegian company (Accenture ANS) to a Swiss company (Accenture Global Services GmbH) for the use of intangible assets for the fiscal years 2006 and 2007.

The Tax Office decided that a part of the royalty payments in 2006 and 2007 – NOK 44.9 million and NOK 22.9 million, respectively – was not deductible costs for Accenture ANS. The total royalty payments amounted to NOK 72.2 million in 2006 and NOK 102.1 million in 2007.

The parties based the royalty payments on a residual profit split method (PSM), which left Accenture ANS a base return of 4.45% of sales and Accenture Global Services GmbH the excess return of 7% of sales (only relevant if the surplus exceeded the base return). Benchmarking analyses supported the rates. In case the company's earnings exceeded the base return and the maximum royalty of 7%, any excess amounts were allocated to Accenture ANS.

In essence, the decision related to the application of the residual PSM and the distribution of the residual. The Norwegian tax authorities argued that the excess earnings (above 4.45%) occurred as a combination of valuable intellectual property (IP) owned by Switzerland, and the use and development of the IP by Accenture ANS. Hence, as Accenture ANS performed non-routine functions, it should be compensated with a share of the residual return that the group generated through its activities in Norway. Oslo City Court ruled in favour of the tax authorities. The judgment was appealed.

Attribution of income to permanent establishment (PE) – oil service industry
The Supreme Court decided on the attribution of income to a deemed PE of a Swiss company – Allseas Marine Contractors S.A. (AMC) – on the Norwegian continental shelf in its June 2011 decision. As the double taxation treaty (DTT) between Norway and Switzerland does not cover the Norwegian continental shelf, the decision was based solely on Norwegian domestic tax law. The Court concluded that the gross income earned by AMC from the contract with the oil company for pipe laying services should be subject to taxation in Norway. The Court did not accept the argument that the PE was to be considered as a service provider to the head office, which should be remunerated on a cost-plus basis. Legal theorists and practitioners criticised the judgment. There are strong arguments to support a different outcome in case the OECD principles for attribution to PEs are applied due to a tax treaty.

Burden of proof
The authorities carry the burden of proving that there is due reason to believe that income charged to tax in Norway has been reduced because of TP. They must also demonstrate that such transactions took place with a related party.

Once the authorities have discharged this burden, if the related party is resident outside the EEA, section 13-1 of the GTA assumes that the relationship is the reason for the income reduction and puts the onus of proving otherwise onto the taxpayer. However, a key Supreme Court case (Baker Hughes 1999) makes the following statement:

"Use of the GTA Section 54 (now GTA Section 13-1) will under any circumstances require that it is more likely than not that the income has been reduced."

In Dowell Schlumberger, a 1995 Supreme Court case, the question of the obligation placed on taxpayers to cooperate with the authorities was tested. The case concerned deductions due in respect of payments to a related (captive) insurance company resident outside Norway.

The authorities argued that they required access to accounts and other information concerning the offshore company, relevant to the question of whether it actually carried on the business of insurance. As the company had not provided such information and therefore had not substantiated its tax deductions, the Court ruled that no tax deduction was allowed for insurance premiums paid. The Court rejected claims that the information requested amounted to business secrets and, therefore, ought not be disclosed.

In a city court case from 2013 regarding the sale of rigs (Thule Drilling), the main question to be resolved was what date the internal rig sale took place. Thule Drilling AS (Thule) sold the rig to an affiliate, which shortly afterwards resold the rig externally with a profit of approximately USD 20 million. Thule claimed that there was a difference in time between the sale and the resale, and that the internal sale had taken place in January 2006, whereas the external sale had taken place in February 2006. There was no written documentation to support that the internal sale had taken place in January, but Thule claimed that there was an oral agreement. It was agreed that the market price of the rig was considerably higher in February than in January, and Thule had accepted that there was a reduction of income if the sale was proved to have taken place in February. The court stated that in cases involving internal transfers, the need for documentation is especially strong. The court also stated that there is a general presumption against assuming that complex, valuable agreements are agreed orally. The court ruled that there was no indication that the transaction had taken place in January, and emphasised that the price was not agreed. The case was not appealed.

Penalties
Norway uses an additional tax (penalty tax), which may be charged administratively under the TAA. The standard rate is 30% (rates of 45% or 60% may be used) of any tax not levied as a consequence of errors made by the taxpayer. Penalty tax is generally not used where the tax issue arises from different interpretations of laws and regulations. However, in situations where the taxpayer is, or should be, aware that the tax situation is uncertain, sufficient information about the transaction should be filed as a part of the tax return in order to avoid use of penalty tax. Ordinary interest for late payment of tax will also be charged. Penalty tax is not tax-deductible. Basically, penalty tax is levied on a strict objective basis.

Documentation

Reporting and documentation requirements

According to the TAA section 4-12, with corresponding regulations, qualifying taxpayers are obligated to file a high-level statement on the type and extent of all inter-company transactions and outstanding accounts in a standardised form. The form is to be submitted together with the tax return. Taxpayers who own or control at least 50% of another entity or are at least 50% owned or controlled by another entity are obligated to file the form unless their total inter-company transactions amount to less than NOK 10 million and the total outstanding accounts amount to less than NOK 25 million.

Qualifying taxpayers shall prepare TP documentation. The documentation shall provide sufficient basis for the tax authorities' assessment of whether the taxpayer's inter-company transactions are in accordance with the arm's-length principle. The TP documentation must be presented to the tax authorities within 45 days upon request. Taxpayers subject to file the high-level statement will also be subject to the TP documentation requirements, unless on a consolidated basis they have fewer than 250 employees and either a turnover of less than NOK 400 million or a total balance of less than NOK 350 million (excluding inter-company turnover/balance items). Taxpayers subject to a special tax under the Petroleum Tax Act or that are involved in transactions with jurisdictions with which Norway does not have a DTT will be subject to the documentation requirement, regardless of the number of employees or the consolidated turnover or balance level.

All inter-company transactions shall be addressed in both the high-level statement and the TP documentation. It should be noted that transactions between Norwegian entities are also to be covered by the high-level statement and are subject to the documentation requirements. In addition, transactions between a Norwegian PE and its foreign head office shall be covered, as shall transactions between a Norwegian head office and its PE abroad.

The taxpayer's tax returns may be disregarded if TP documentation is not submitted in accordance with the regulations within the deadline provided by the taxing authorities, ref. TAA section 8-2 (2). Nevertheless, TAA section 8-2 (2) must be interpreted in coherence with GTA section 13-1 about assessment of income and wealth in communities of interest, i.e. the conditions in GTA section 13-1 (reduction of income or wealth due to community of interest) must be fulfilled in order for the tax authorities to perform a reassessment in TP cases. In practice, failure to submit adequate TP documentation entails that the level of proof that the taxing authorities has to provide in a GTA section 13-1 TP case to a certain extent is reduced. Previous legislation that entailed that failure to submit TP documentation resulted in the loss of right of appeal was revoked in 2011.

The basis for the taxpayer's tax assessment shall be based on a discretional assessment if the taxpayer fails to submit the TP form (RF-1123) in accordance with the regulations, ref. TAA section 8-2(1).

The ordinary statute of limitations is ten years, ref. TAA section 9-6. However, in cases where taxpayers have provided correct and complete information to the taxing authorities, the statute of limitations is two years, i.e. if a taxpayer submits TP documentation that is not in accordance with the regulations the ordinary statute of limitations applies.

A penalty tax of 30–60% is levied on reassessed income if a taxpayer provides incorrect or incomplete information to the taxing authorities and the misrepresentation has resulted in, or could have resulted in, a tax benefit, ref. TAA section 10-2.

Anyone that provides, or contributes to provide, incorrect or incomplete information to the taxing authorities and that understood, or should have understood, that this act could have resulted in tax or duty benefits is punished with fines or imprisonment up to six years, ref. TAA section 12-1 and section 12-2.

Liaison with customs' authorities
The tax and customs' authorities cooperate with the tax authorities in TP investigations. While TP adjustments agreed for corporation tax purposes normally would not be reflected in the returns for customs duty or VAT purposes, there is a high risk that information exchanged between the different authorities might lead to further investigation and adjustments.

Transfer pricing controversy and dispute resolution

Selection of companies for audit

Companies or groups might be selected for TP audit in several ways, and there is no specific guidance on how to select companies for an audit. An audit might be of a general nature such as an audit of the company as such (i.e. a combination of various tax issues), or the tax authorities might audit specific issues/areas.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Under the TAA, the tax authorities have extensive powers to collect information relevant to settling the tax liabilities to Norway as well as to the level of income subject to Norwegian taxation. The authorities may request any information they believe to be relevant to the point in question including information on the profitability and functions of all parties in a value chain.

There is also a general obligation on taxpayers to substantiate their tax position and to cooperate with the authorities in the provision of information relevant to deciding their tax liabilities.

If the taxpayer does not submit the requested information or does not cooperate in the provision of information, as in the Supreme Court case of Dowell Schlumberger (*see Burden of proof, above*), the tax authorities may base an assessment on the available facts.

The tax authorities have increasingly, without advance notice, made visits to companies to secure evidence from archives, PCs and other sources.

The audit procedure

Investigations are conducted using correspondence, interviews and site visits, as appropriate. Once the investigation has been undertaken, the authorities complete a report that indicates any areas in which they disagree with the taxpayer. They then make proposals for a revised assessment. The taxpayer responds to this report in writing, rejecting any arguments or conclusions of the authorities with which she/he disagrees. Any supporting documentation is included in this response. The authorities then review the position in the light of the taxpayer's response and notify the taxpayer of their decision. Both the tax audit reports and the taxpayer's responses tend to be comprehensive, both in respect of the description of the facts and the legal argumentation.

Audit period

In general, the tax authorities may go back ten years, but usually the audit period is three years. However, if correct and sufficient information has been provided in the tax return, the tax authorities may only change the assessment in disfavour of the taxpayer for the two previous years.

There are special rules originating from case law that apply to the audit period of TP audits. In the Supreme Court's decision in the Baker-Hughes case, the Court decided that an internal price 'deviating significantly' from the arm's-length price, in itself constituted incorrect information, and consequently the audit period was ten years. In this case, the internal price was 40% higher than the arm's-length price.

In a decision from 2013 (Statoil captive insurance), the Supreme Court clarified its statements in the Baker Hughes case, stating that a 40% deviation from the arm's-length price is a minimum requirement for a 'significant deviation'. Consequently, internal prices deviating less than 40% does not constitute incorrect information leading to a ten-year audit period.

Revised assessments and the appeals' procedure

If the taxpayer disagrees with the decision of the tax authorities, she/he may appeal to the appropriate tax appeals board. For companies taxed by the Oil Taxation authorities, there is a special appellate board for petroleum tax.

If the taxpayer disagrees with the appellate board's decision, she/he may take the case to court. Norway has three levels of courts (city/district court, Court of Appeals and Supreme Court) but no specialised tax court.

There is a general rule based on court practice (Supreme Court decisions in the Agip and Sundt cases) stating that the courts cannot take into consideration new documentation that the taxpayer loyally should have provided to the tax authorities during the audit or the appeals' process.

Resources available to the tax authorities

The Norwegian tax authorities are divided into five regions (North, East, South, West and Mid-Norway), which include several local tax offices. In addition, there are three central tax offices: the Central Tax Office – Foreign Tax Affairs (part of Tax West), the Central Tax Office for Larger Enterprises (part of Tax East), and the Oil Taxation Office. There is also the Tax Directorate, which is a central tax authority.

The central tax offices have a high level of competence and resources, and often pursue aggressive positions in TP cases. The local tax authorities also have developed substantial resources and are in a position to handle an extensive TP investigation. The Tax Directorate often investigates TP issues and supports/assists the local tax authorities.

The resources targeted at TP have increased considerably and are likely to be increased further over the coming years. The tax authorities have used a significant amount of resources in developing various IT solutions. As a result, it is easier for the tax authorities to extract relevant information and also to follow up more closely with respect to TP issues.

Use and availability of comparable information

Use

Where the taxpayer is involved in the offshore oil industry, Norway has specific legislation that deals with the pricing of petroleum (Petroleum Tax Act) for tax purposes, as noted above (*see Other regulations*).

In respect of all other commodities and services, the brief provisions of section 13-1 of the GTA lay down the arm's-length principle and its application and as mentioned above there is a reference to the OECD TP Guidelines.

Availability

Basically, the published annual accounts of companies are the only information available in Norway about the businesses of third parties. For some business sectors, statistical data concerning gross profits is also published, but this is not detailed to the degree of discussing individual companies. Some tax offices also issue a yearly overview of the tax assessment on an anonymous basis.

A potential problem in this area is the fact that the tax authorities may compare data/pricing used by other taxpayers, without being able to give any detailed information regarding the data the taxpayer is compared against (hidden comparables). Consequently, in such situations a taxpayer may find it difficult to prepare an appropriate defence.

The issue of using secret comparables was treated by the Supreme Court in a decision dated 27 March 2015 (Total LPG). The Appeals Board's use of secret comparables in this case was accepted by the Supreme Court. The Supreme Court referred to section 3.36 of the OECD TP Guidelines, and stated that the use of secret comparables was, as a starting point, not prohibited:

"A.4.3.3 Information undisclosed to taxpayers

3.36 Tax administrators may have information available to them from examination of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts."

The Supreme Court noted that the Appeals Board had disclosed detailed information on the selection criteria for choosing comparable contracts, as well as much anonymised information as possible about the contracts actually chosen as comparables. The Supreme Court also noted that the Appeals Board was prohibited from giving away more information due to the confidentiality obligation in the TAA section 3-13. The Supreme Court ruled that this was sufficient in order to provide the taxpayer with 'adequate opportunity to defend its own position', *cf. the quote form the OECD TP Guidelines section 3.36*. In its overall assessment, the Supreme Court put some weight on the fact that Total had refused to disclose the Total Group's LPG resale contracts, which would have made it possible to use the resale method instead of a CUP method based on secret comparables.

Benchmarking

While Norwegian tax authorities previously were skeptical towards benchmark studies in general, they now vigorously test benchmarks supplied by taxpayers and also carry out their own benchmarks. Due to the financial crisis from 2008, it is to be expected that benchmarks which rely on companies in Greece, Italy, Portugal and Spain will be subject to specific scrutiny.

The Appellate Court's decision from June 2012 in the Vingcard case is of interest also from a benchmarking perspective. The Appellate Court accepted a true-up payment to a US sales subsidiary, based on the application of the transactional net margin method (TNMM) method where the target returned on sales' margin was supported by a benchmark study. The Court dismissed allegations from the tax authorities to the benchmark study, including that the comparables did not operate in the same industry as the tested party. The court assumed that no independent entities operated in the same industry as the tested party and that the comparables could be used as a representative range. Most important, the decision ensured a clear case-law basis for the acceptance of the TNMM and benchmark studies for Norwegian tax purposes. At the same time, based on the decision, extraordinary circumstances related to the business of the tested party (affecting income and/or costs of the company) must be considered when applying the TNMM method. If not adjusted for, such circumstances may lead to lack of comparability and hence affect the arm's-length nature of the applied method.

Risk transactions or industries

The TP focus in Norway is on a wide range of topics such as the financing of business operations (thin capitalisation and interest levels), on intragroup service arrangements, distribution, agency and commissionaire arrangements, intangibles attribution of income to PEs, etc.

In two cases – the Tandberg case (District Court March 2009) and the Dynea case (Appeal Court June 2009) – Norwegian tax authorities aggressively pursued their claim that inter-company share prices were not arm's length, and in a third – the Telecomputing case (Appeal Court October 2009) – they similarly challenged the calculation of loss on an inter-company receivable. Although the taxpayer prevailed in all of these cases, the fact that they were tried before the courts is a strong indication of the Norwegian tax authorities' general aggressiveness on TP and their willingness to go to trial in TP cases.

Limitation of double taxation and competent authority proceedings
Generally, in order to hinder or limit double taxation, the GTA provides for a tax credit system for direct and indirect foreign taxes paid by a Norwegian taxpayer or its subsidiaries. Tax treaties signed post-1992 generally are based on the credit method. Older tax treaties typically are based on the exemption method.

Double taxation arising, due to a TP issue, often will have to be handled through a competent authority process. The competent authority in Norway is the Ministry of Finance. The authority for specific cases is, however, delegated to the Tax Directorate.

Advanced pricing agreements (APAs)
As of yet, there are no general formal APA procedures enacted in Norwegian legislation. There is one specific exception, however: Transactions involving the sale of dry gas may be covered by APAs in accordance with the Petroleum Tax Act section 6. In total, there have been five APAs since the dry gas APA Institute was introduced in 2007. Experience shows that the dry gas APAs demand a lot of resources both from the tax authorities and the companies – the APA period is often more than six months, involving requests of large amounts of information. Most APA negotiations have ended up with the companies accepting the OTO's advance pricing rulings.

The Central Tax Office for Large Enterprises has announced that a department with national responsibility for handling bilateral TP mutual agreement procedure (MAP) and APA cases will commence operations as of 1 January 2015. The department will operate on delegation of authority from the Ministry of Finance and will have a staff of ten. There is an increased focus with the tax authorities to achieve an enhanced relationship with taxpayers and requests for advance clearance in TP cases are frequently welcomed. A general system of binding advance rulings has been introduced, but issues with respect of TP will not be handled.

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Joint investigations
Norway has in a number of cases been involved in joint TP investigations with other Nordic countries, and there is nothing to prevent Norway from undertaking joint investigations with the authorities of any other country.

Comparison with OECD Guidelines
Norway is a member of the OECD and has approved the OECD Guidelines. Traditionally, Norwegian tax authorities have seemingly had a preference for the CP method in TP issues. It has, therefore, often proved difficult to get full acceptance for other methods such as the PSM or the TNMM. However, the tax authorities currently seem to be developing a more varied approach, and lately have signalled that they may apply the PSM.

The GTA section 13-1(4) makes reference to the OECD TP Guidelines. These 'shall be taken into account'. The reference is to the guidance on the arm's-length principle and the TP methods. It is also assumed that the reference includes the OECD guidance on business restructuring.

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Oman, The Sultanate of

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Overview

Oman does not currently have specific transfer pricing (TP) guidelines, although transactions between related parties and the arms-length principle are explicitly addressed in the Omani tax law. There is no specific guidance on acceptable methods for determining the arm's-length price. However, the Omani tax law contains provisions that allow tax authorities to recharacterise transactions based on the arms-length principle.

Country	Oman, The Sultanate of
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Documentation is not mandatory.
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	25% of the difference between tax due and the tax declared and 1% of the unpaid tax/month

Oman, The Sultanate of

Introduction

The Omani tax law does not have detailed TP regulations; however, it does have provisions that imply that transactions between related parties should be conducted in a manner that is consistent with the arms-length principle. It is expected that these provisions would allow the Secretary General for Taxation (Secretary General) to reallocate revenues and expenses in transactions between related parties so as to reflect the returns that would have resulted if the parties were independent or unrelated. Finally, the Secretary General may use their discretion to examine a taxpayer's records and to request underlying documentation. As such, the Secretary General can scrutinise related-party transactions, reallocate/adjust revenues and expenses, disregard transactions and/or reclassify a transaction whose form does not reflect its substance.

Oman has entered into double tax treaties with a number of countries that provide for reduced rates of withholding tax. There are also agreements that are still being finalised or awaiting the ratification process. These countries together include Algeria, Belarus, Belgium, Brunei, Canada, China, Croatia, Egypt, France, India, Iran, Italy, Korea, Lebanon, Mauritius, Moldova, Morocco, Netherlands, Pakistan, Russia, Seychelles, Singapore, South Africa, Sri Lanka, Sudan, Sweden, Switzerland, Syria, Thailand, Tunisia, Turkey, the United Kingdom, Uzbekistan, Vietnam and Yemen.

Legislation and guidance

In May 2009, Oman issued a new tax law, the Royal Decree No. 28/2009 (the Omani Tax Law), which was effective from tax year 2010. The Omani Tax Law had provided for the Minister responsible for Financial Affairs to issue Executive Regulations. In early 2012, the Executive Regulations were finally published to take effect from 1 January 2012 and to apply to all accounting years ending after 1 January 2012. These Executive Regulations are considered an inseparable part of the Omani Tax Law and they provide clarifications and specify guidelines and rules in relation to the provisions of the Omani Tax Law.

The Omani Tax Law contains no detailed TP rules or guidelines, nor does the Executive Regulations explicitly define specific TP methods. However, transactions between related parties and the arms-length principle are explicitly addressed in the Omani Tax Law.

Articles 125, 132 and 133 of the Omani Tax Law provide that a company is deemed as being related to another company if that first company has a control over the other company or both the company and the other company are controlled by a common third party.

These articles elaborate further that a company is deemed as controlling the other company if it has a direct or indirect control over the commercial and business matters of the other company including in the following situations:

- The first company has a greater share of the capital or voting rights (than the other shareholders) in the other company.
- The shareholding of the first company in the other company entitles it to receive the largest portion of the income distribution when the other company distributes its total income.
- The shareholding of the first company in the other company entitles it to receive the largest portion of the distributed assets upon termination or dissolution of the other company.

The Omani Tax Law and the Executive Regulations do not expressly define inter-company transactions. However, Article 125 of the Omani Tax Law implicitly refers to inter-company transactions as transactions entered into by related parties.

Penalties

The tax year is usually the calendar year. Taxpayers can choose to file their tax returns on the basis of a year-end other than 31 December, provided permission is granted in advance by the Omani tax authorities and the year-end is consistently adhered to by the taxpayer.

The Omani Tax Law confers wide powers on the Secretary General for requesting information. Based on experience, notwithstanding the presentation of audited accounts, we are aware that the tax department requests very detailed information and supporting documentation relating to revenue and expenses. Failure to provide such information or the provision of incorrect information can result in an additional assessment by the Secretary General and/or various penalties on the company and/or the officer responsible for providing the information. Where the taxpayer fails to declare correct income in the tax return for any tax year, the Secretary General may impose a fine not exceeding 25% of the difference between the amount on the basis of the correct taxable income and the amount of tax as per the return submitted. Additionally, the incorrect declaration leads to interest payments, because the additional tax should have been paid earlier (i.e. at the original filing date). According to the Omani Tax Law, 1% on the additional tax (plus penalties) per month must be paid.

Documentation

The Omani Tax Law and the Executive Regulations do not contain a specific documentation requirement. However, payments to group entities/foreign affiliates normally receive in-depth scrutiny from the Secretary General to ensure that the profits are not transferred to avoid payment of tax. In order to be prepared for such scrutiny, taxpayers would be advised to maintain appropriate documentation in order to establish that these transactions were entered into on an arm's-length basis.

Transfer pricing controversy and dispute resolution

Given the absence of TP guidelines with specific TP provisions (including delineation of specified TP methods), there are no specific rules regarding burden of proof. However, taxpayers are expected to produce sufficient TP documentation (and other supporting documents including inter-company agreements, schedules and invoices) to support their declared transactions on the tax return. But there is uncertainty around what constitutes acceptable TP documentation to the Omani tax authorities.

Additionally, no specific TP cases have been brought in Omani courts. However, summarised below are a few insights, based upon our experiences with the Secretary General:

- All inter-company payments are scrutinised in detail to ensure that the profits are not transferred to avoid payment of tax.
- In the absence of any detailed TP guidelines in Oman, it is difficult to anticipate which TP method would be an acceptable method from the perspective of the Omani tax authorities. Often, the most widely accepted methods (such as the ones specified by the Organisation for Economic Co-operation and Development [OECD] Guidelines and widely accepted by several countries) may not be accepted by the Omani tax authorities.

- The reaction of the Omani tax authorities to the acceptability of any TP method can therefore said to be almost arbitrary and taxpayers can expect a fair amount of uncertainty around whether a particular method may be considered acceptable by all tax inspectors (i.e. a method that may be accepted by one tax inspector may not necessarily be the method of choice of another tax inspector).

Comparison with OECD Guidelines

Although Oman is not an OECD member, it acknowledges the importance of the OECD Guidelines as international best practice.

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Palestinian Territories

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Overview

The Palestinian Territories currently do not have specific transfer pricing (TP) laws or guidelines. In addition, there is no recognition of a group for taxation purposes in the Palestinian Territories. Corporation Income Tax is levied on taxable profits above 125,000 Israeli new shekels (ILS) at a rate of 20%.

Country	**The Palestinian Territories**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	No
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	No
TP documentation	
Can TP documentation provide penalty protection?	No TP documentation requirements
When must TP documentation be prepared?	No TP documentation requirements
Must TP documentation be prepared in the official/local language?	No TP documentation requirements
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No TP documentation requirements
Do penalties or fines or both apply to branches of foreign companies?	No TP penalties
How are penalties calculated?	No TP penalties

Palestinian Territories

Introduction

The Palestinian Territories currently do not have any recognition of a group for taxation purposes. Accordingly, there are no TP guidelines governing intragroup transactions for multinational companies operating within the Palestinian Territories.

Legislation and guidance

There is currently no TP legislation and guidance in the Palestinian Territories.

Penalties

Every individual and corporation has to submit its tax return in the Palestinian Territories. The minimum fine for delay in submitting the self-declaration of tax is 3,000 ILS (860 United States dollars) for corporations. There are no specific TP penalties in the Palestinian Territories.

Documentation

There are currently no TP documentation requirements in the Palestinian Territories for multinational companies.

Transfer pricing controversy and dispute resolution

There is currently no TP audit and dispute resolution process in the Palestinian Territories.

Comparison with OECD Guidelines

There are currently no TP guidelines in the Palestinian Territories.

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Peru

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Overview

The legal framework currently governing Peruvian transfer pricing (TP) rules are set forth in Articles 32 and 32(A) of the Peruvian Income Tax Law (PITL), amended in 2003, as well as in Chapter XIX of the PITL's regulations, published in December 2005 and effective as of January 2006. Moreover, in 2012, in the context of a broader tax reform, some changes were introduced to these rules, which are effective since January 2013.

Country	**Peru**
OECD Member?	No
TP Legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border intercompany transactions?	Yes
Does TP legislation apply to domestic intercompany transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP Documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	June
Must TP documentation be prepared in the official / local language?	Yes
Are related party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the company´s net revenue

Introduction

In January 2001, the PITL introduced TP rules for transactions between related parties (domestic and international), as well as transactions with entities operating in tax havens. These rules are applicable for all type of goods and services transactions agreed between related parties or carried out with entities based in low-tax jurisdictions (LTJ) or tax havens.

As mentioned above, the legal framework currently governing Peruvian TP rules are set forth in Articles 32 and 32(A) of the PITL. Article 32 of the PITL establishes the application of the arm's-length principle. In addition, the PITL sets forth formal compliance obligations for qualifying taxpayers, which include, among others, filing out an Informative Return describing the transactions carried out with related parties or parties resident in a LTJ or tax havens, on an annual basis; preparing a TP study and keeping supporting documentation. In that regard, not complying with the Peruvian TP rules, or its related reporting obligations, might determine the application of the penalties established in the Peruvian Tax Code.

Since the Peruvian TP rules are included in the PITL, it is important to mention the last changes in the Peruvian income tax rate applicable for domiciled companies or legal entities with operations in Peru and in the dividend tax rate. On December 2014, the Congress approved Law 30296, which established a progressive reduction in the income tax rate for entities with operations in Peru and an increase in the dividend tax rate during the period 2015 to 2019. The following table shows these changes:

Legal Entities		
Fiscal Year	**Income Tax Rate**	**Dividend Tax Rate**
2015-2016	28%	6.8%
2017-2018	27%	8.0%
From 2019	26%	9.3%

Legislation and guidance

Arm's-length principle

The PITL establishes that all goods and services transferences carried out between related parties, must comply with the arm's-length principle. According to the PITL, the arm's-length value is the price normally obtained by the same entity when engaging in transactions with non-related parties under the same or comparable conditions. In such cases when comparable transactions (also known as 'internal comparable') are not available, the arm's-length value will be determined by reference, according to prices agreed upon between two unrelated parties for the same or comparable transactions.

Scope of application

According to the PITL, as amended in 2012, TP rules will be applicable to all transactions entered into by a Peruvian taxpayer with a related party or with an individual or entity residing in a territory considered as LTJ or tax haven. However, TP adjustments must be applied only when the TP determined has led to a lower income tax payment, when compared to the tax payment determined in compliance with the arm's-length principle (regulation also clarifies that tax detrimental occurs, not only when the taxpayer avoids totally or partially the tax but also when the taxpayer achieves the deferral of the tax from one period to another or when the taxpayer determines higher tax losses).

Until year 2012, Peruvian TP rules were also applicable to determine the Value-added Tax (VAT) and the Selective Consumption (excise) Taxes, except when the adjustment made determined an increase in refundable VAT (the application to VAT taxes was repealed in 2012 Income Tax Law changes.). In addition, Peruvian TP rules are not applicable for customs valuation, since the World Trade Organisation's rules apply.

It should also be noted that the Peruvian TP rules considers the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations adopted by the Council of the Organisation for Economic Co-operation and Development (OECD Guidelines) as the source of interpretation.

Transfer pricing adjustments to the taxable base

From January 2013, an adjustment to the taxable base will be attributed to the fiscal year, following the attribution rules determined by Law. In this regard an adjustment could now be split in several years. In order to analyse if the Income Tax paid is lower than the Tax determined in compliance with the arm's-length principle, the independent effects of each transaction must be taken into account. In other words, only those transactions that determine a lower income tax to be paid should be taken in account for the adjustments.

Regarding the free of charge transactions, the adjustment should be imputed to: (i) the period or periods in which the income should have been accrued if the transaction had taken place in the case of a domiciled company, or (ii) to the the period or periods in which the expense should have been accrued if the transaction had taken place in the case of a non-domiciled company.

In addition, if the intercompany transaction is agreed with a related non-domiciled party, the adjustment will be applicable to the Peruvian taxable income or the income of the non-domiciled party.

Transactional Analysis

According to the PITL, the determination of the market value must be made transaction by transaction, if possible. Only in the cases in which different transactions are closely related or involve continuing operations, the evaluation of these transactions could be performed in an aggregate approach.

Related parties

According to Peruvian law, two or more individuals, companies, or legal entities are considered as related parties if any one of them participates, directly or indirectly, in the administration, control or capital interests of the others; or if the same individual or group of persons participate, directly or indirectly, in the administration, control or capital interests of several individuals, companies or legal entities.

In addition, Peruvian Law will consider that two individuals, companies or legal entities are related if any transaction existing between them is carried out by a third party or intermediary, whose only purpose would be to serve as a vehicle to enclose or hide a transaction between them.

The PITL regulations specify, among others, the following cases of economic relationship:

- In case an individual or legal entity owns, directly or indirectly, more than 30% of the capital stock of another company or legal entity.
- In case more than 30% of the capital stock of two or more companies or legal entities belong to one individual or legal entity, directly or through a related third party.
- In case two or more companies or legal entities have one or more Directors or Managers in common, with full decision capacity.

- In case the 80% of the sales and service provisions rendered by a resident individual, company, or legal entity, in previous fiscal year to the one under analysis, in favour of an individual, company or legal entity which sales in return represent at least 30% of its purchases during the same period (this fact has to be verified in the average of a three-year period).
- In case an individual, company or legal entity has or exercises 'dominant influence' over the management decisions of one or more companies or legal entities.
- In case two or more companies or legal entities have consolidated financial information.

Transfer pricing methods

According to Article 32A of the PITL, there are six TP methods ruled by Peruvian Law. Its regulations will determine the applicable criteria to determine the most appropriate TP method to use for each case.

The following TP methods are acceptable according to the PITL:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CP).
- Profit split method (PSM).
- Residual profit split method (RPSM).
- Transactional net margin method (TNMM).

An amendment made in 2012 to the PITL adds a new provision to the application of the CUP method. This provision is applicable in case an individual or legal entity imports or exports commodities or goods with a known price in transparent markets on behalf of a related party (or an entity domiciled in a LTJ or tax haven) and an international intermediary participates in the transaction, though it will not be the final receiver of the imported or exported goods.

It is important to note that this method will not be applicable when:

- the taxpayer has entered into future contracts with hedging purposes for the importation or exportation of the mentioned goods
- it is documented that the international intermediary complies with the following:
  - Actual existence in the place of domicile (possessing a commercial establishment where its business is managed, complying with legal requirements for incorporation and registration, as well as for the filing of financial statements). The assets and risk incurred by the international intermediary must be related to the volume of the transactions entered into.

Its main activity should not be to obtain passive income or act as an intermediary in the sale of goods with the members of the group. The main activity will be understood as the one which represented the biggest amount of transactions during the last fiscal year.

In general terms, the application of the above-mentioned methods is based on doctrine and by the OECD Guidelines, which nowadays have explicit legislative recognition as source of interpretation in the body of the PITL (prevailing always the PITL). Regarding comparability, the PITL (notice that there is a factual sort of order of preference for method selection that establishes in the first place the comparison of prices, followed by the comparison of gross margins) and finally the comparison of operating margins establishes two general guidelines:

1. Two transactions are comparable as long as none of the differences existing between the transactions compared or between the characteristics of the entities involved may materially affect the price or free market margin.
2. Two transactions may be comparable even if (1) above is not met (i.e. the conditions of the transactions compared are not similar or the same), as long as adjustments can be made (and are made) to offset the effects of such differences.

Use and availability of comparable information

Neither the law nor the regulations have established criteria as to which are the acceptable sources for comparable information. According to the Tax Code, the Tax Administration (TA) could use third-party confidential information; but, the Peruvian Tax Court in its resolution N°02649-5-2006 indicated that in case a company has internal comparables the TA should consider them as well as a source of information. If the TA uses third-party information, the taxpayer has limited access to this data through only two nominated representatives. Nevertheless, it is understood that the authorities should only use public available information; otherwise, constitutional rights to due process and defence could be violated.

Due to the limited amount of local public information on comparable transactions, the use of foreign comparable transactions is acceptable; despite this, in this case, necessary adjustments should be made. For instance, Article 32 of the PITL explicitly establishes that to determine comparable transactions and, in the event that there is no locally available information, taxpayers are allowed to use foreign companies' information, provided that the necessary adjustments are made to reflect market differences. Said provision puts an end to the problem of having very little information available in countries where the financial market is underdeveloped, and, therefore, the access to public financial information of companies is very limited.

Furthermore, specific information on local industries can be obtained from a number of industry associations, such as the *Sociedad Nacional de Industrias* for the manufacturing industry, *Sociedad Nacional de Minería*, *Petróleo y Energía* for the energy, mining and oil industry, *Asociación de Exportadores* for the exports trade, the *Superintendencia Nacional de Banca*, *Seguros y AFP* for the banking industry, *Asociación Nacional de Laboratorios Farmacéuticos* for the pharmaceutical industry, *Cámara Peruana de la Construcción* for the construction industry, and the *Confederación Nacional de Comerciantes* for the trade industry, among others. Membership of these organisations might be required to obtain information. A second possibility for obtaining local comparable information is through the *Superintendencia del Mercado de Valores*, the agency that supervises the stock exchange market and where publicly traded companies file their financial statements.

Also, it's important to mention that the amends made to the PITL in 2012 stipulate the prohibition of the use of comparables in which one of its unrelated parties is related to one of the entities in the intercompany transaction under review.

Penalties

Resources available to the Tax Authority

There are special units being trained within the Peruvian tax authority in order to deal specifically with TP issues. At present, TP issues are being dealt with by the Peruvian tax inspectors mainly during the course of a general tax audit and at a smaller and more incipient level by the TP unit. Since the beginning of fiscal year 2010, the TP unit sent out several information requests to a substantial number of companies, these actions have continued in 2014 and 2015.

Additional tax and penalties

Each TP infraction is penalised based on the Tributary Tax Unit, called *Unidad Impositiva Tributaria* (UIT). For 2015, one UIT is 3,850 nuevos soles (PEN) (approximately 1,260 United States dollars [USD]). The following constitute violations of the related TP obligation:

- Not keeping the documentation and information, reports, and analysis related to the operations that could create tax obligations during the period of time of the obligation will result in a penalty of 0.3% of the net income; it may not be less than 10% of a UIT or greater than 12 UITs.
- Not providing the TP informative return according to the deadline set by the law will result in a penalty of 0.6% of the net income; it may not be less than 10% of a UIT or greater than 25 UITs.
- Not exhibiting or submitting the documentation and information that supports the calculation of transfer prices according to law will result in a penalty of 0.6% of the net income; it may not be less than 10% of a UIT or greater than 25 UITs.
- Not including documentation and information that supports the calculation of transfer prices according to law will result in a penalty of 0.5% of the net income. (When the penalty is calculated over the annual net income it may not be less than 10% of a UIT or greater than 25 UITs.).
- Any adjustments to transfer prices as a result of information omitted in tax returns will automatically trigger a penalty equivalent to 50% of the taxes imposed on the adjustment, plus interest.

Documentation

Informative return

Beginning fiscal year 2006, taxpayers are required to file a TP Informative Return form if they have carried out transactions with related parties or parties resident in LTJ or tax havens for a value of at least PEN 200,000 (approximately USD 65,570) (when calculating, all inter-company loans that accrued an interest rate of zero must not be taken into consideration. However, if all other inter-company transactions exceed the amount set by the TA, the inter-company loans must be informed and documented). By value, the law understands the sum of the income accrued during the fiscal year and the acquisition of goods and/or services made during the fiscal year without distinction or netting between positive and negative values, as long as these derive from transactions with related parties or parties resident in LTJ or tax havens. The return form needs to be lodged by a taxpayer if there were transferred goods to related parties or parties resident in LTJ or tax havens with a market value lower than its cost. The TP Informative Return form must be lodged every year on a date set each year by the tax authority through the issue of a resolution. The obligation to lodge the TP return form on the TP report is due in June.

Transfer pricing report

Early in 2001, TP regulations were passed under the PITL. The regulations established the obligation for taxpayers to keep documentation and information about the methods used to determine their transfer prices agreed with related entities. The documentation must evidence the criteria used to establish the transfer prices and any other elements relevant to the transaction. A similar obligation was established for taxpayers in connection with their transactions carried out with entities resident in LTJ or tax havens.

In addition to the TP Informative Return, beginning fiscal year 2006 the taxpayer is obliged to have a TP study (*Estudio de Precios de Transferencia*) if it has carried out transactions with foreign and local related parties or parties resident in LTJ or tax havens for a value greater than PEN 1 million (approximately USD 327,800) and if the revenue accrued by the taxpayer exceeds PEN 6 million (approximately USD 1,967 million). However, in cases where a TP report is not required, the taxpayer must have information and documentation that prove that transactions with related parties were conducted at an arm's-length value. Since FY2012, the TP report must be filed along with the TP informative tax return.

Specific requirements for documentation

According to section g of Article 32-A of the PITL, the following documentation must be included in order to support the TP calculation:

- Related parties' information and documentation that supports the related parties' relation.
- Information regarding the transactions performed between related parties or residents in tax heavens: date, amount, currency and contracts or agreements.
- Taxpayer's financial statements of the fiscal year, elaborated according to the generally accepted accounting principles (GAAP).
- In case of related parties that are part of an economic group:
  - General description of the companies or entities that are part of the group.
  - Detailed information of the organisational structure of the group, including the description the activities that each entity develops.
  - Information regarding each entity included in the economic group:
    a. Partners of each company or entity, indicating the percentage that they represent in the capital or equity of the entity.
    b. The place of residence of each of the partners and members of the company or group entities, with the exception of those partners that are purchasers of capital or assets placed by public offering through stock exchanges or centralised negotiation mechanisms.
    c. The place of residence or domicile of each of the companies.
    d. The list of group companies authorised to negotiate in the stock market, indicating the name of the entity and the place where such authorisation was granted.
- Factors that influence the setting of prices:
  - Compensation operations between the group companies.
  - Cost-sharing agreements within the group.
  - Fixing prices or distribution of profits contracts.
- Documentation that supports the production costs and costs of goods and/or services sold, including information regarding related parties and third parties.
- Working papers with the calculation made by the taxpayer in order to adjust differences resulting from the application of the comparability criteria, according to the most appropriate valuation method.

- Working papers that contain the determination of the interquartile range and the values resulting from the methodology applied.
- Any other relevant document or information that contributes to prove that the prices, used in transactions with related parties or residents in LJT or tax havens, were the ones that would have been used by independent parties in similar conditions.

Minimum information in the transfer pricing report

According to Article 32-A of the PITL, the TP report must include at least the following information regarding the transactions that generate taxable income and/or costs or deduction in determining the tax base:

- Information of the transactions with related parties:
  - Agreements or contracts guiding the relation between related parties.
  - Product and/or services offered by the taxpayer and markets in which the taxpayer operates, with the description of the activities.
  - Information about the intangibles involved.
  - Distribution of the operation result derived from the application of the TP methodology.
  - Organisational structure of the group and the companies or entities.
- Financial-economic information of the taxpayer:
  - Financial statements.
  - Financial forecast of the activities developed by the taxpayer.
  - Description of the basic financial flows.
- Functional Information:
  - Description of the functions performed by the company or organisation, in relation to global functions performed by the economic group including distribution, quality control, advertising and marketing, human resources, inventory and research and development.
  - Description of the risks assumed by the company or entity.
  - Assets assigned to the company or entity.
- Operations in which TP rules applies:
  - Description, from a technical legal, economic and financial point of view, of the operations in which TP applies.
  - Purchase and/or sale of goods, services, transfer of intangibles or other economic operations to independent third parties during the period of evaluation.
- Methodology and Comparability Analysis:
  - Information available about similar operations performed by other companies or entities that operate in the same markets and information about the prices, if known, of comparable transactions with third parties.
  - Description of the sources of information used.
  - Explanation of the reasons for selecting the information used.
  - Description of the methodology used, highlighting the economic circumstances that affected the analysis.
  - Calculation of adjustments made.
  - Value and/or range of prices or profit margins arising from the application of the methodology used.

This list of minimum information in the TP report, in any case, is limited to additional information that, in the taxpayer opinion, help to support, in a better way, the value or price range resulting from the application of the methodology chosen.

Transfer pricing controversy and dispute resolution

Advance pricing agreements

The PITL makes expressed reference to the possibility of entering into advance pricing agreements (APA). The amendments made in 2012 have included the possibility of entering into APAs for transactions between domiciled parties or between the Peruvian TA and the TA of other countries.

Chapter XIX of the PITL regulations sets forth the APA procedures and characteristics. According with the aforementioned regulations, the APA objectives are: to set price, amount of compensation, profit margin, and the TP methodology supporting the values the taxpayer will use in future operations with related parties or with entities operating in LTJ or tax havens. The APAs cannot be modified or unilaterally terminated, except when any of the related parties involved in the APA has been found guilty by court for tax or customs crimes or if the terms of the APAs are not met.

Under the procedure, the taxpayer proposes the TP method, the comparable transactions or enterprises, and the supporting data, including years analysed, adjustments made to the selected comparable, the exact price or range of prices, amount of compensation or profit margin; also the hypothesis used for the proposal.

After reviewing the proposal, the TA might approve it, approve a different version, or reject it. The TA will have a 24-month maximum period to review the proposal. If after this period it has not issued a response, the proposal is automatically considered rejected.

The APAs will be applicable to the fiscal year during which it was approved as well as for the three subsequent years.

Burden of proof

The burden of proof lies within the taxpayer. However, a challenge by the tax authority would require some supporting evidence to be accepted by the tax courts (TC). However, it is expected that taking into account the new rules, the burden of proof will be transferred to the authorities, so long and APA was duly entered and if proper TP supporting evidence is in place.

Legal cases

The following are some important TC rulings regarding the prices for transactions:

- In the case of a company specialising in the sale of glass, the tax authority considered there was an undervaluation of sales in two of the company's business lines due to the fact that the cost of sales for some months were above the sales value and because there were discounts of 40% granted to a single client which happened to be a related party. The TC decided that market value does not necessarily have to be above the cost, a situation that can derive from technological factors, higher financial costs in comparison with other companies, and access to market of raw materials, among others. Thus, what should have been done is to prove that market value was above that considered by the company. Finally, in order to deny the discounts granted, the TC stated that the tax authority should have verified that these were not granted to other clients, that it was not a usual practice or that they did not correspond to the volume of items bought or payment conditions. Therefore, it cannot be argued that the discounts do not comply with current legislation.

- In a case against a company dedicated to the melting and commercialisation of steel, the TC confirmed the adjustment made to discounts granted to clients for achieving certain volume goals. The TC stated that for such discounts to be valid, they must be offered to clients complying with certain criteria (general principle) and should be granted uniformly. However, the company did not grant the discounts to certain clients that met such criteria. Thus, the deduction of all discounts was denied.
- The Peruvian TA, based on a valuation report found during the audit process, pointed out that the company owner of a hotel had undervalued the sales price agreed for the transfer of the right to use the hotel unit, which included assets and/or furniture. The company argued that the transfer value used corresponded to the valuation report with a discount of 1.1564%. The TC considered that the company should have used the value set forth in the valuation report with no adjustments.
- In a case against a company dedicated to the renting of helicopters, the tax authority challenged the comparable selected in the TP study. The company rendered transport services to its related party and to an independent party, so the TA considered that an internal comparable existed. The company's counterargument was that the services were not similar, due to the differences in the types and heights of the flights performed with the related and the third party. The TC is still evaluating the case.
- In the case against a company that distributes IT products, the tax authority disqualified the reclassifications of accounts made by the company to analyses the imports from related parties. The company maintained its position and obtained a report from a third party accounting expert to support it. Additionally, the tax authority modified the sample of comparable companies, as they did not agree with the qualitative filters applied.
- In a case against a glass distributor, the tax authority questioned the TP method used for the analysis of imports of glass from related parties. They considered that the RPM should be applied. Nevertheless, the company argued that the best method was the TNMM as a gross profit evaluation would require some adjustments to account for the differences in the classification of costs and expenses between the company and the comparable companies.
- The TA has not recognised accounting debit notes which attempt to correct the profits of a Peruvian company by the increase of expenses alleging TP adjustments. The TA has mentioned that the debit notes can only be issued to correct the value of an asset, or properly identified assets, but not profits.
- In the case of a metal commodities trader, the TA has not recognised the application of the CUP method since it affirms that the products under analysis are mineral concentrates and, as a consequence, it is not possible to prove the market value of each one of the components that determines the price (deductions, penalties, price participation, etc.), therefore preferring the application of TNMM method.
- In the case of a company that deposited money in an international related party under a cash pooling agreement, the TA recharacterised the transaction considering that the related party was not a bank or a financial institution authorised to operate as such by the regulator in its own country and, therefore, it was not a deposit but a loan that had to be reattributed with lending rates rather than deposit rates.

Comparison with OECD Guidelines

Even though Peru is not an OECD member, the PITL sets forth that the OECD Guidelines should be used only to interpret TP regulations as long as they do not oppose the provisions adopted in the PITL. Therefore, the OECD Guidelines are used in Peru as a source of interpretation of the TP regulations.

Peru

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Philippines

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Overview

Transfer pricing (TP) has gained significant attention from the Bureau of Internal Revenue (BIR). In recent years, there has been an increasing BIR challenge to inter-company practices and arrangements of multinational companies and local conglomerates.

Revenue Regulations (RR) No. 02-2013 or the Philippine Transfer Pricing Guidelines (TP Guidelines), which were issued in 2013, formally require taxpayers to prepare and maintain TP documentation for their cross-border and domestic inter-company dealings. With the issuance of the TP Guidelines, the BIR is seen to intensify its efforts to scrutinise TP issues. Taxpayers, as a result, can expect a surge in TP audits, and requests for TP documentation in the near future.

Even prior to the issuance of the TP Guidelines, the BIR has been raising TP issues in tax investigations, which resulted in assessments of several hundred millions up to billions of pesos in deficiency taxes. In more recent tax audits, taxpayers are being asked to explain their TP policies/arrangements. Therefore, companies should have officers who understand and are able to explain the inter-company transactions and their TP mechanics, on top of adequate documentation.

Country	**Philippines**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes

Philippines

Country	Philippines
When must TP documentation be prepared?	At the time the related parties develop or implement any arrangement or review these arrangements when preparing tax returns. Documentation must be submitted to tax authorities upon request during a tax audit.
Must TP documentation be prepared in the official/local language?	English
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No transfer pricing-specific penalties. General penalty rules apply.
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a fixed amount. In case of assessment, on additional tax payable

Introduction

The Philippines' statutory TP rule is patterned after what is now section 482 of the US Tax Code. It was codified in 1939 and has remained unchanged since. Court decisions have also confirmed that section 482 of the US TP regulations can be used as guidance when applying the Philippine TP rules. The BIR also relies heavily on the Organisation for Economic Co-operation and Development (OECD) TP Guidelines. In fact, the Philippine TP Guidelines issued in 2013 are largely based on the principles set out in the OECD TP Guidelines.

Following the issuance of the TP Guidelines, the BIR is starting to gain more sophistication in their knowledge and understanding of TP issues. It has created a TP team coming from different divisions of the BIR, who are specially tasked to increase their knowledge of, and to focus more on, TP. The BIR has been sending members of this team to attend TP seminars in other countries, and also conducts its own structured TP training for its personnel.

Section 11 of the Philippine TP Guidelines also discusses the concepts of advance pricing arrangements (APA) and mutual agreement procedure (MAP). However, separate guidelines for the requirements and application process for these arrangements still need to be issued by the BIR.

In the case of APAs, the BIR has exposed for comments, draft regulations, and invited interested entities to participate in deliberations. The APA Guidelines may be issued before the end of 2015.

Legislation and guidance

The statutory rule on TP is found in section 50 of the National Internal Revenue Code (NIRC). The rule has remained essentially unchanged since 1939, when it was patterned after the TP rule in the US Revenue Act of 1934. Section 50 allows the BIR to allocate income and deductions between related parties as a means to prevent tax evasion or clearly reflect the amount of income earned by each party.

Section 50 is augmented by audit guidelines issued by the BIR. In 1998, the BIR issued Revenue Audit Memorandum Order (RAMO) No. 1-98 (Audit Guidelines and Procedures in the Examination of Interrelated Group of Companies), which provides audit guidelines and procedures in relation to the examination and review of transactions between related parties. In 2009, the BIR issued Revenue Memorandum Order (RMO) No. 64-99, which provides for the arm's-length standard for determining the correct gross income and deductions between two or more enterprises under common control, particularly for transactions that involve indebtedness. And, in 2008, the BIR issued Revenue Memorandum Circular (RMC) No. 26-08, or the Interim TP Guidelines, which reiterated that as a matter of policy the BIR subscribes to the OECD Guidelines.

On 23 January 2013, the Secretary of Finance through the BIR issued the Philippines' TP Guidelines, which as stated previously, provided more detailed guidelines in applying the arm's-length principle for transactions between associated enterprises. The salient features of the Philippine TP Guidelines are further discussed in the following paragraphs.

Applicability

The TP Guidelines are applicable to cross-border and domestic transactions between associated enterprises.

Thresholds

The TP Guidelines do not provide specific TP thresholds. Therefore, in general terms, all cross-border and domestic transactions between associated enterprises may be scrutinised by the BIR.

Definition of 'associated persons', 'control' and 'controlled'

The TP Guidelines consider two or more enterprises as 'associated enterprises', if one participates directly or indirectly in the management, control, or capital of the other, or if the same persons participate directly or indirectly in the management, control, or capital of the enterprises. Associated enterprises are also referred to by the TP Guidelines as related parties.

On the other the hand, the TP Guidelines refer to 'control' as any kind of control, direct or indirect, whether or not legally enforceable and however exercisable or exercised. The Guidelines further provide that control shall be deemed present if income or deductions have been arbitrarily shifted between two or more enterprises.

The TP Guidelines also refer to 'controlled transaction' as any transaction between two or more associated enterprises.

Arm's-length principle
The TP Guidelines adopt the use of arm's-length principle as the most appropriate standard in determining transfer prices of related parties. Under the TP Guidelines, the application of the arm's-length principle shall follow a three-step approach, as follows:

- Step 1: Conduct a comparability analysis.
- Step 2: Identify the tested party and the appropriate TP method.
- Step 3: Determine the arm's-length results.

The TP Guidelines further provide that the foregoing steps should be applied in line with the key objective of TP analysis in order to present a logical and persuasive basis to demonstrate that transfer prices set between associated enterprises conform to the arm's-length principle.

Comparability analysis
In performing comparability analysis, the similarities and differences in the characteristics that are found in the associated enterprise transaction and the independent party transaction should be examined. Likewise important in comparability analysis is the comparison of the economically significant functions performed, risks assumed and assets employed by the associated enterprise with those of the independent party, which is referred in the TP Guidelines as the 'functional analysis'.

In addition to prescribing the conduct of the comparability and functional analyses, the TP Guidelines also require the performance of a comparison between the commercial and economic conditions of the associated enterprise transaction and the independent party transaction.

Tested party and appropriate transfer pricing method
Tested party
Under the TP Guidelines, the tested party is the entity to which a TP method can be most reliably applied to and from which the most reliable comparables can be found. The BIR likewise requires sufficient and verifiable information on the entity to be qualified as a tested party.

Transfer pricing methodologies (TPM)
The selection of a TPM is aimed at finding the most appropriate method for determining the arm's-length result in a particular case, taking into account, various factors. The BIR does not have a specific preference for any one method. As such, the method that provides the most reliable measure of an arm's-length result shall be used. For the purpose of selecting the most appropriate method, the following conditions should be taken into account:

- the respective strengths and weaknesses of each of the TPM
- the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis
- the availability of reliable information (in particular on uncontrolled comparables) in order to apply the selected method and/or other methods, and
- the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

The arm's-length methodologies provided under the TP Guidelines include the comparable uncontrolled price (CUP) method, the resale price method (RPM), the cost-plus method (CPM), the profit split method (PSM) and the transactional net margin method (TNMM).

Profit level indicator (PLI)
In applying the selected TPM, the choice of PLI, which measures the relationship between profits and sales, costs incurred, or assets employed should also be given due consideration. Under the TP Guidelines, the commonly used PLIs include return on costs, return on sales and return on capital employed.

Determination of the arm's-length results
The arm's-length result is generally arrived at after the appropriate TP methodology has been determined and applied on the data of independent party transactions.

In case the TP analysis arrives at a single figure, or specific ratio (e.g. prices or margin) that could be relied upon to establish whether a transaction is arm's length, the same shall be applied to the particular transaction. However, if the analysis leads to a range of ratios, the use of the range to determine an arm's-length price shall be applied, provided that the comparables are reliable.

Penalties
The TP Guidelines do not provide for TP-specific penalties; hence, TP adjustments are governed under general penalty rules. Generally, a 25% surcharge is imposed on tax deficiencies. In addition, interest is imposed on the deficiency tax (but not on the surcharge) at 20% per annum. A compromise penalty of up to 50,000 Philippine pesos (PHP) is also imposed.

In case of failure to submit information and documents (e.g. TP documentation) required by the BIR, a penalty not exceeding PHP 50,000 is generally imposed.

Documentation
The TP Guidelines require taxpayers to keep adequate TP documentation so that they can (i) defend their TP analysis, (ii) prevent TP adjustment arising from tax examinations, and (iii) support their applications for MAP. The BIR does not require TP documentation to be submitted when the tax returns are filed. However, the TP documents must be contemporaneous, such that the documents should exist, or be brought into existence at the time the associated enterprises develop or implement any arrangement that might raise TP issues, or upon review of these arrangements when preparing tax returns.

Moreover, the preservation and retention of TP documents shall follow the retention period provided under existing laws, such as the NIRC and related regulations. Currently, the regulations provide for a ten-year period to retain information and documents.

The details of the TP documents as required under the TP Guidelines are as follows:

- organisational structure
- nature of the business/industry and market conditions
- controlled transactions

- assumption, strategies, policies
- cost contribution arrangements (CCA)
- comparability, functional and risk analysis
- selection of the TP method
- application of the TP method
- background documents
- index to documents.

Transfer pricing controversy and dispute resolution

Legal cases

The Philippines generally follows the pronouncements of its own courts, particularly that of the Supreme Court, in interpreting or applying Philippine laws. However, when Philippine law is based on an equivalent provision in the US Tax Code, the decisions of American courts interpreting said US provision are given some persuasive effect in applying such Philippine tax laws, particularly in the absence of a prior ruling or interpretation on the matter.

In two Philippine cases relating to TP, the Court of Tax Appeals (CTA) has acknowledged that section 482 regulations indeed have persuasive effect in this jurisdiction.

In the Cyanamid case (1995, affirmed by the Court of Appeals [CA] in 1999), the CTA held that the BIR had acted in an arbitrary, unreasonable and capricious manner when it made no apparent attempt to verify the comparability of pharmaceutical products being compared under a CUP method analysis.

On the other hand, in the Filinvest case (2002), the CTA upheld the imputation of interest by the BIR on an interest-free loan. The CTA also required the BIR to allow correlative relief by way of an interest deduction, based on section 1.482-(1)(g) of the US regulations. Upon appeal, however, the CA reversed this decision, citing that the imputation of interest rule does not apply to alleged indebtedness, which is in fact a contribution of capital; the CA considered the loan/advances made in the case to be capital contributions. In 2011, the Supreme Court (SC) affirmed the decision of the CA. The SC ruled that the BIR's power to allocate gross income does not include the power to impute 'theoretical interest', because there must be actual or, at the very least, probable receipt or realisation by the taxpayer of the income that is being allocated. In this case, both the CA and the SC also recognised that under Philippine law, interest cannot be imposed unless expressly stipulated in writing.

The same issue on imputation of interest was presented in the Belle Corporation case (2005), where the CTA ruled in favour of the taxpayer, deciding that RMO No. 63-99 was inapplicable to the facts of the case.

Two other cases decided by the CTA in early 2005, Avon Products and ING Barings Securities, validated the notion that the initial burden to prove that inter-company pricing complies with the arm's-length principle lies with the taxpayer. However, once proof is provided, the onus shifts, and the revenue authority should then be able to prove that its basis for questioning the taxpayer's policy has sufficient support. In these two cases, the courts ruled in favour of the taxpayers after the BIR failed to produce evidence to refute the explanations made by the taxpayer's witnesses during the course of trial.

Burden of proof
As a general rule, taxpayers should be prepared to justify their transactions to the BIR. The NIRC affords the commissioner of the BIR fairly strong assessment and collection powers. However, the burden of proof shifts to the BIR once the taxpayer is able to demonstrate that its pricing complies with the arm's-length principle, as demonstrated by the 2005 cases of Avon Products and ING Barings Securities.

Tax audit procedures
There are no TP-specific audits in the Philippines. Transfer pricing issues are raised within the context of the regular tax audits conducted by the BIR.

Nevertheless, due to the issuance of the TP Guidelines and the increasing focus of the BIR on TP, it is expected that TP issues will more likely be raised during regular audits in the future.

Selection of companies for audit
Generally, the BIR issues tax audit programmes to inform taxpayers of the tax audit policies and procedures as well as various criteria (e.g. movement of taxes paid every year) it has set in determining which taxpayers are likely to be investigated for that particular year or period.

Audit procedure
The tax examination process starts with the issuance of a Letter of Authority by the BIR. This authorises a specific BIR team, consisting of a supervisor and revenue examiners, to gather documents and financial information from the taxpayer, such as books of accounts and other accounting records, for the purpose of determining whether the taxpayer has deficiency tax liabilities.

After the examination of the records, if the BIR determines that sufficient basis exists to assess the taxpayer for deficiency tax, it issues a Preliminary Assessment Notice (PAN). Upon receipt thereof, the taxpayer is given 15 days to submit a written response including additional documents supporting its position. If the BIR does not agree with the taxpayer's position, a Formal Assessment Notice (FAN) shall be issued within 15 days from filing of the reply to the PAN.

Appeals' procedure
Within 30 days from receipt of a formal demand and assessment notice, a taxpayer must file an administrative protest with the BIR. The taxpayer then has 60 days from date of filing of the protest letter to submit all the required documents supporting the protest. In case the BIR issues a formal decision, or fails to issue a decision within 180 days from submission of complete documentation, the taxpayer may appeal the matter to the courts. Failure to meet these requirements or to file a timely appeal renders the assessment final, executory and demandable.

Resources available to the tax authorities
The BIR's computerisation program has significantly enhanced its abilities to detect and to apprehend tax evaders. The computerised system has also, to date, generated a significant increase in tax collections, and there are indications that the BIR will further leverage the system for its other revenue-generating efforts. However, whether such efforts include challenge of taxpayers' TP policies and arrangements, remains to be seen.

In 2012, the BIR issued RMO No. 05-12, prescribing updated guidelines in taxpayer profiling and benchmarking activities to help address collection problems, plug tax leakages and implement risk-to-revenue-based audit and enforcement activities. Under this issuance, the agency shall adopt the Performance Benchmarking Method as a surgical measure to detect tax leakages and improve collections on value-added tax, income tax and other taxes. This signifies the BIR's intent on using benchmarking as a tool to conduct its audits and enforcement activities, which could potentially include TP audits.

Use and availability of comparable information

To be able to justify that TP arrangements under examination are arm's length, a taxpayer must demonstrate the compliance of the transfer prices with the arm's-length principle through adequate documentation, which includes benchmarking.

Tax authorities

To date, the BIR is not yet using external databases for purposes of obtaining comparable information. In some of its recent TP assessments, the BIR obtained comparable information within its internal database, which includes the annual tax returns and other financial information submitted by companies registered with the BIR.

Taxpayers

There are no specific TP rules with respect to the selection of comparable companies. However, in practice, the BIR strongly prefers local comparables. Regional comparables are considered only upon showing that there are no available local comparables.

Further, in the Philippines, there are no available electronic databases that could easily provide a sufficient number of Philippine companies for benchmarking. Therefore, the identification of local comparable companies and/or transactions through benchmarking still needs to be done manually.

For purposes of identifying local comparables, taxpayers (usually through third-party consultants) use publications and public databases such as the Philippine Securities and Exchange Commission (SEC) database. The SEC database is the repository of business information and data (i.e. articles of incorporation, general information sheet and audited financial statements, among others) on registered corporations in the Philippines. The SEC database contains documents that were submitted by Philippine corporations when reporting or disclosing required information including their main business activities to the said regulator.

Risk transactions or industries

The BIR has recently intensified challenges on the TP arrangements of multinationals, and the areas of concern are more varied. Whereas previously, the BIR would be content with brief explanations on payments for management services, they now require further proof on the validity of these charges, where they were performed, and in cases of those rendered in the Philippines, sometimes asking for additional documentation such as passport details of visiting foreign employees and the basis for the charges. The BIR now requires that actual benefit by recipient of services be shown through proof of actual provision of services.

The provision of outbound services is also attracting more attention from the BIR. Previously, a 5%–10% markup on cost could be considered safe harbour. However, it is now more difficult to consider even a 10% markup as defensible, especially if the services involve high value-adding activities such as R&D, technical design, or knowledge processing outsourcing services. Benchmarking is therefore the key. Also, the BIR appears to be monitoring any sharp decline in profitability in certain companies' operations, once they finish their tax holiday, which is generally available for these sunshine industries. In any case, this is an area that the BIR appears to be looking into more closely in the future.

The BIR is also looking at the royalty rates being paid to foreign licensors. These payments are at risk since these are subject to final withholding tax in the Philippines and are generally claimed as deductible expenses by the companies. Recent developments likewise indicate that the BIR is questioning the propriety of these payments. One particular issue is whether or not it is appropriate for companies doing contract manufacturing for export, to still pay royalties when the products are not sold to third parties but only to foreign affiliates.

Limitation of double taxation and competent authority proceedings

The Philippines has a wide treaty network. The concept of MAP is generally contained in a number of Philippine treaties and is discussed under the TP Guidelines. Therefore, it is reasonable to expect that the BIR would welcome application for tax relief through MAP. However, the BIR has yet to issue separate guidelines on the application of MAP.

Advanced pricing agreements (APA)

Under the TP Guidelines, APA is made available to taxpayers who are engaged in cross-border transactions. APA is an agreement entered into between the taxpayer and the BIR to determine in advance an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto) to ascertain the transfer prices of associated transactions over a fixed period of time. The APA is not mandatory, but may be advisable since the purpose of the APA is to reduce the risk of TP re-examination and double taxation.

The requirements and application processes for APA will be covered by separate guidelines to be issued by the BIR. The BIR is now finalising the guidelines on APA and is expected to release the guidelines within 2015. Nevertheless, taxpayers have started expressing their interest in applying for APA even without the formal APA guidelines. For its part, the BIR has expressed its willingness to participate in discussions on APA application.

Comparison with OECD Guidelines

The Philippines is not a member of the OECD. However, the BIR relies heavily on the OECD Guidelines and treaty models with respect to international tax issues. As earlier mentioned, the TP Guidelines are largely based on the arm's-length methodologies set out in the OECD Guidelines. Taxpayers, therefore, should be reasonably assured as long as the Philippine TP and OECD Guidelines are properly applied and followed.

It remains to be seen how the Philippine authorities will view the OECD and G20 initiatives on addressing the international issue of base erosion and profit shifting (BEPS) among multinationals.

Philippines

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Poland

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Overview

Polish transfer pricing (TP) regulations were introduced first in 1997 and were amended several times to reflect the conclusions of the Organisation for Economic Co-operation and Development (OECD) and European Union (EU) Joint TP Forum. These regulations are generally in line with the OECD Guidelines and apply both to cross-border as well as domestic transactions.

The tax authorities have shown particular interest in TP issues recently. On 18 July 2013, an amended Transfer Pricing Decree of the Minister of Finance entered into force. The amendments essentially reflect the 2010 changes to the OECD Guidelines and the results of the work of the EU Joint TP Forum. The most significant recent amendments are summarised below:

- Explicit regulations on business restructurings and their TP aspects (which are applicable also to the past transactions as the provisions are treated only as a clarification of the arm's-length principle).
- Guidelines on documenting low value-added services including examples of low value-added services.
- Exemplary list of shareholder costs.
- Description of the benchmarking process.
- Guidance on the application of the profit split method (PSM).
- Tri/multilateral negotiation procedure regarding elimination of double taxation in case of adjustments to incomes of related entities.
- Comparable uncontrolled price (CUP) method is no longer the preferred TP method.

In February 2014, the Ministry of Finance published additional guidelines on business restructurings, which are in line with Chapter IX of the OECD Guidelines.

Further, in April 2014, the Minister of Finance set up a specialised TP team. The main objective for the team is to support tax offices and tax control offices in tax audits they conduct.

Finally, as of the beginning of January 2015, an amended CIT Law came into force. As a result, the catalogue of entities obliged to prepare TP documentation and scope of activities undertaken, required to be described in the TP documentation has been extended. Additionally, new regulations on corresponding adjustments between domestic taxpayers came into force.

Country	**Poland**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	There is no statutory deadline for preparing TP documentation. Taxpayer has to submit the TP documentation within seven days upon the request from the tax authorities. However, taking into account the short deadline, preparing TP documentation in advance immediately after the closing of a financial year is recommended.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes (only the fact that such transactions had been concluded)
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	In case the tax authorities assess additional taxable income, it is subject to standard corporate income tax (CIT) rate (19%). In case TP documentation is not submitted within seven days upon the request of the tax authorities, additional income is subject to penalty tax rate of 50%. In addition, personal fines may be imposed.

Introduction

Poland has well-established TP regulations that apply to cross-border as well as domestic transactions. These regulations draw heavily on the OECD Guidelines (Poland has been a member of the OECD since 1996).

In January 2006, Poland introduced advance pricing agreement (APA) legislation which, from 1 January 2007, also applies to the allocation of profits to permanent establishments (PEs).

The statutory thresholds for the documentation requirements (introduced in 2001) are relatively low, and the requirements apply to a wide range of transactions. Since 2007, legislation also requires taxpayers to document the allocation of profits to PEs.

Polish tax authorities have been particularly interested in TP issues over the last period, which resulted in:

- amending the TP decrees and CIT Law, which introduced among others, provisions on business restructurings and corresponding adjustments between domestic taxpayers as well as extended the scope of obligation to prepare TP documentation
- publishing additional guidelines on business restructurings, and
- setting up a specialised TP team within the Ministry of Finance, which is going to support tax offices and tax control offices in scrutinising related-party transactions.

Transfer pricing has been regularly indicated by the tax authorities in the annual tax audit plans as one of the key areas of focus. Importantly, the tax authorities may also apply the regulations on business restructurings to past transactions – as the provisions are regarded as clarification of the general arm's-length principle.

Legislation and guidance

Definition of related parties

Polish TP regulations apply to domestic and cross-border relationships. However, the definitions of these relationships differ. A Polish and a foreign company are considered 'related' if one of the following three conditions is met:

- A Polish taxpayer participates directly or indirectly in the management or control of a company located abroad or holds a share in its capital.
- A foreign resident participates directly or indirectly in the management or control of a Polish taxpayer or holds a share in its capital.
- The same legal or natural person, at the same time, participates directly or indirectly in the management or control of a Polish and a foreign entity or holds shares in their capital.

Polish companies are considered 'related' when one of the following conditions is met:

- A domestic entity participates directly or indirectly in the management or control of another domestic entity or holds a share in its capital.
- The same legal or natural person participates, at the same time, directly or indirectly, in the management or control of two domestic entities or holds a share in their capital.
- Relationships of a family nature, resulting from employment contracts or common property, exist between i) two domestic entities or ii) persons involved in their management, control or supervision.
- The same person combines managerial, supervisory or controlling duties in both entities.

Tax havens
Transactions that result in payments to companies located in tax havens are also subject to TP regulations, regardless of whether they are conducted by related parties or not. A decree of the Minister of Finance lists countries applying harmful tax competition (tax havens).

Methods for determination of the arm's-length price
From 1 January 1997, corporate income tax (CIT) law and personal income tax (PIT) law have presented the methodology for determining arm's-length prices by use of the:

- comparable uncontrolled price (CUP) method
- resale price method
- reasonable margin (cost plus) method.

Where these methods cannot be applied, transactional-profit methods (PSM and transactional net margin method [TNMM]) may be used. As previously indicated, the CUP method is no longer the preferred method for determination of transfer prices.

The Minister of Finance also issued two decrees on the methods and procedures for determining taxable income by estimation and the methods and procedures of eliminating double taxation in case of a TP adjustment (further 'TP decrees'). One decree concerns PIT law, while the other concerns CIT law. However, for all intents and purposes, both decrees contain the same rules and regulations.

The new decrees introduced more detailed regulations regarding comparability and new provisions concerning the procedure of eliminating double taxation in case of TP adjustments. The decrees also present in more detail the application of the five pricing methods in a manner similar to that outlined in the OECD Guidelines. The decrees oblige the tax authorities to verify transfer prices using these methods.

As indicated in the Overview section, the decrees were amended on 18 July 2013. The amendments included introduction of regulations on business restructurings and low value-added services as well as detailed guidance on benchmarking process. Furthermore, appendices to the decrees provided exemplary lists of low value-added services and shareholder costs, which do not create value added for subsidiaries and should not be treated as tax-deductible.

Advance pricing agreements (APAs)
From 1 January 2006, a taxpayer may conclude an APA with the Minister of Finance to confirm the appropriateness of the taxpayer's TP policy. The purpose of an APA is to agree in advance the arm's-length character of the terms of the transactions between related parties. From 1 January 2007, APAs also cover the attribution of profit to PEs. As a result of concluding the APA, the local tax authorities may not challenge the arm's-length character of transactions conducted on the terms approved within the APA.

The tax law allows for the following types of APAs:

- Unilateral APA – for transactions between domestic entities or a domestic entity and a foreign entity.
- Bilateral/multilateral APA – issued by the Minister of Finance after obtaining foreign tax authority's consent.

The administrative fee for the APA is approximately 1% of the transaction value. However, depending on the type of APA, the fee may range from approx. 1,250 to 50,000 euros (EUR). The APA decision includes:

- Determination of the entities covered by the agreement.
- Determination of the type, subject and the value of the transaction covered by the agreement, as well as the period concerned.
- Determination of the TP method, method of calculation of the transfer price and rules of application of this method including all crucial assumptions.
- Period during which the decision remains in force.

An APA may be concluded for a maximum period of five years, with the possibility of extending the period by another five years.

Penalties

Transfer pricing assessment

If the tax authorities conclude that related-party transactions are not in line with the arm's-length principle, they assess additional income that the taxpayer should achieve if the transactions were concluded at arm's length.

The additional income is subject to regular CIT rate (19%) and penalty interests (10%) are imposed. If the taxpayer does not submit TP documentation upon request of the tax authorities, a penalty CIT rate of 50% is imposed instead of the regular rate and penalty interests are also due.

Personal liability

If the tax authorities successfully challenge related-party transactions, the fiscal penal proceedings against a person responsible for the financial reconciliations start automatically. Under the Fiscal Penal Code, a member of the board or other person responsible for a company's financial matters, who would be held responsible for filing the tax returns showing understated amounts of tax (or taxable base), could be accused of the fiscal crime of exposing the tax to be understated. Consequently, such person could be subject to a fine up to approx. EUR 4 million and/or imprisonment for up to five years.

In practice, the most usual punishment is a fine; penalty of imprisonment is extraordinary. Nevertheless, the fact that a verdict is reflected in the national register of convicted persons (typically visible for a period of five years) may be even more severe for a given person because convicted persons are not allowed to perform certain public functions and may also not be allowed in certain cases to be members of management boards.

A fine may also be imposed on a person responsible for financial reconciliations if a taxpayer fails to submit TP documentation with the statutory deadline, i.e. within seven days upon the request of the tax authorities. The fine may reach up to 120 daily rates. The level of daily rate is set by the court in each case and may range from approx. EUR 14 to EUR 5,600. Additionally, submission of false documentation may result in imposing a fine of up to 240 daily rates.

Documentation

From 1 January 2001, the CIT law imposes compulsory documentation requirements on taxpayers concluding transactions with related parties and for transactions resulting in payments to entities located in tax havens. Entities are obliged to prepare documentation comprising of the following:

- Functional analysis (including functions performed, assets engaged and risks assumed).
- Determination of costs including the form and terms of payment.
- The method and manner of calculating the profit and determination of the price applied.
- Determination of expected benefits – in the case of transactions relating to purchase of intangible products or services.
- Business strategy adopted – if it influenced the value of the transaction.
- Other factors – if they influenced the value of the transaction.

The reporting thresholds are EUR 20,000 for transactions with entities located in tax havens and EUR 30,000–100,000 (depending on the company's share capital and the nature of the transaction) for transactions with related parties.

From 1 January 2007, the same requirements apply to the allocation of profit to a PE. Also, as a result of the amended CIT Law, as of the beginning of January 2015, entering into a partnership agreement, joint venture agreement and any other agreement of similar nature should be documented in line with the above requirements. Additionally, any transaction concluded with related partnerships (including limited partnerships) should be documented as well.

Transfer pricing controversy and dispute resolution

Legal cases

Each year the Polish tax offices and tax control offices conduct a significant number of tax audits concerning related-party transactions – in 2012, approx. 3,300 proceedings relating to TP issues according to the data published by the Ministry of Finance.

Furthermore, approx. 40–50 administrative court verdicts related to TP are issued every year. The court verdicts are formally not a binding source of legal regulations in Poland. Nevertheless, they are often used as interpretative guidelines. Some of these court verdicts settled, among others, the matter that the tax authorities should take into account during TP audits, not only local regulations, but the OECD Guidelines as well, for interpretation purposes.

Transfer pricing audit team in the Ministry of Finance

In April 2014, the Minister of Finance set up a new team, which is going to concentrate on scrutinising related-party transactions concluded by taxpayers. In particular, the team will support tax offices and tax control offices in conducting TP audits, assist in selecting taxpayers who should be audited and assessing TP risk in audited transactions. In general, the team should increase efficiency of tax audits.

Burden of proof

Taxpayers are required to maintain TP documentation describing the conditions applied in related-party transactions. However, the burden of proof that non-arm's-length prices or other conditions were applied, falls on the tax authorities.

When examining transfer prices, the tax authorities must determine the arm's-length value of a transfer using the method(s) previously applied by the taxpayer, provided that:

- the taxpayer established the transfer price using a traditional transaction-based TP method
- the taxpayer submits documentation supporting the choice of a particular method, based on which the price calculation is performed and TP documentation required by the CIT law
- the objectiveness and reliability of the documentation submitted – based on which a transfer price was calculated – cannot be reasonably questioned, and
- another method would not have been self-evidently more appropriate.

Tax audit procedures
Transfer pricing is usually examined as part of a CIT audit. Foreign-owned companies that have been loss-making are likely to be targeted. The tax authorities can request any information deemed necessary for the investigation and have full search powers. Non-compliance with information requests can result in severe penalties.

A particular characteristic of the audit procedure is the short timeframe that taxpayers have to respond to TP assessments:

- Upon completion of a tax audit, the tax inspector issues a written protocol setting out their preliminary findings.
- The taxpayer has 14 (calendar) days to respond to this protocol in writing, presenting their explanations and objections.
- Within 14 days, the tax inspector issues a document of formal information on the method of dealing with the taxpayer's response.
- Subsequently, before issuing the tax decision, the tax authorities inform the taxpayer about the intended decision. The taxpayer has seven days to review the data collected during the tax audit and to present their opinion.
- The taxpayer can expect a tax decision or formal closing of the proceeding if the audit finds the taxpayer's reconciliation to be correct.
- The taxpayer may appeal in writing to the higher authority (the tax chamber) within 14 days.
- The verdict of the tax chamber may be further appealed to the administrative court within 30 days.
- The taxpayer has the right to appeal against the court's verdict to the Supreme Administrative Court within 30 days.

Tax investigations may examine related-party transactions that are not time-barred. Transactions are subject to the statute of limitations after five years from the end of the year in which tax returns concerning those transactions were filed (i.e. effectively, six years). Penalty interest (currently 10% per annum) may be charged on underpaid tax. Penalty interest is tax-non-deductible.

Comparable information
Where possible during a tax audit, the Polish tax authorities try to use internal comparables (sometimes without carrying out all necessary adjustments). They also use external comparables drawing on data gathered through controls of comparable taxpayers. Here, however, due to commercial and fiscal secrecy, the taxpayer may have difficulty obtaining access to such data.

The tax authorities have access to databases to establish comparable information. However, it is rarely evident that they use such comparables during tax audits. The tax authorities take a relatively sceptical view of foreign comparable data. In practice, while preparing benchmarking studies, domestic comparables should be examined first. If there is not sufficient information concerning domestic comparables, the search could be extended to comparables within the Central and Eastern Europe region. If there is still not sufficient comparable data, a pan-European benchmarking study may be conducted.

Rulings

Amended regulations relating to interpretations of the tax law by the tax authorities and the Minister of Finance were introduced on 1 July 2007. Currently, two types of rulings are issued by Polish tax authorities:

- General rulings – issued by the Minister of Finance where there are differences in the interpretation of tax regulations by the tax authorities and apply to all taxpayers.
- Individual rulings – issued by tax chambers appointed by the Minister of Finance and apply only to the case of the requesting taxpayer.

The request for an individual ruling is filed on a special form – ORD-IN – and should include:

- The background of the case.
- The applicant’s standpoint with respect to the interpretation of the tax law.
- A declaration that the case subject to interpretation is not subject to a tax proceeding, tax control or earlier tax decision. If this condition is not met, the ruling is not binding and the person applying may be fined under the Fiscal Penal Code.

An individual ruling may not be harmful for the taxpayer (i.e. if the taxpayer follows the ruling, no penalty interest or sanctions under the Fiscal Penal Code may be imposed). If the ruling is issued before the transaction starts, no tax other than that resulting from the interpretation may be imposed on the taxpayer with respect to the transaction. This does not apply if the ruling is issued after the transaction started.

An individual ruling may be amended by the Minister of Finance at any time. If the amendment is less favourable for the taxpayer, the taxpayer is entitled to apply the earlier ruling until the end of the current accounting period.

The tax authorities must issue individual rulings within three months (this may be extended in complicated cases). The fee for an individual ruling is approx. EUR 10 per question in the request.

Individual rulings cannot be used to confirm the correctness of the TP method – APA proceedings are applicable in such cases.

Comparison with OECD Guidelines

As mentioned above, the Polish TP regulations generally follow the OECD Guidelines. Although they are not binding in Poland, they could be used for interpretation and clarification purposes. The most recent amendments to the Polish TP regulations adopted provisions on business restructurings and benchmarking processes, which strictly follow the OECD Guidelines. However, the Polish tax authorities prefer local comparables, if available.

However, Polish TP regulations also include some unique provisions, in particular:

- The traditional TP methods should be considered before applying transactional profit methods.
- Transfer pricing documentation should be prepared in Polish and should describe among others i) costs incurred by the parties to the documented transaction including the form and terms of payment, ii) expected benefits – in the case of transactions relating to purchase of intangible products or services.
- The transactional approach is usually applied in Poland, i.e. each related-party transaction and profitability achieved in this transaction are analysed separately. Therefore, segmentation of profit and loss account is usually required.

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Portugal

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Overview

Corporate income tax reform (Law number 2/2014, of 16 January) introduced a number of measures with tax implications regarding the Portuguese transfer pricing (TP) regime. The main facts to highlight are the following:

- The concept of related entities revised through the increase of the percentage in the share capital of a company from 10% to 20%.
- The possibility of taxpayers requesting the conclusion of an advanced pricing agreement (APA) on a multilateral basis.
- The situation of significant dependency between two entities are now limited to the ones resulting from a legal obligation (in the past it was referred to as the economic/commercial dependency).
- It is now expressly referred that the TP regime is applicable for permanent establishments (PEs) located in foreign jurisdictions.

Country	**Portugal**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	To be prepared until the 15th day of the seventh month after the end of the fiscal year by taxpayers who achieved a turnover of at least 3 million euros (EUR) in the previous fiscal year.

Portugal

Country	Portugal
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	May vary from EUR 750 to EUR 150,000

Introduction
Although the arm's-length principle has been included in the Portuguese tax law for many years, it generally was not enforced, due to a lack of clarity and supporting regulations. However, this changed in December 2000, when new Portuguese TP legislation was enacted.

Legislation and guidance
Law number 30-G/2000 of 29 December 2000, which entered into force on 1 January 2001, by amending Article 57 of the Portuguese Corporate Income Tax (CIT) Code, introduced detailed TP rules. This Article was subsequently changed into Article 58 by decree-law number 198/2001, dated 3 July 2001 (decree-law 198/2001) and changed again into Article 63 by decree-law number 159/2009, dated 13 July 2009 (decree-law 159/2009). The new TP documentation rules are applicable to tax years starting on, or after, 1 January 2002.

Article 63, number 13 of the CIT Code states that a Ministerial Order from the Minister of Finance will regulate, among others, the application of the TP methods, the type, nature and contents of the documentation and the procedures applicable to (corresponding) adjustments. This Ministerial Order, number 1446-C/2001, dated 21 December 2001 (Ministerial Order 1446-C/2001), was published in The National Gazette on 14 January 2002.

Article 63 CIT code
The key elements of the TP rules are as follows:

- The concept of 'special relations' between entities is broadly defined including situations ranging from statutory to economic dependency, and also certain family relations.
- A set of defined methodologies for evaluating transfer prices and the comparability factors that should be taken into account when assessing their arm's-length nature.
- The 'best method' or 'most appropriate method' for every transaction or series of transactions should be considered.
- Extensive requirements regarding how taxpayers justify and document their TP arrangements.
- A shift in the burden of proof from the tax authorities to the taxpayer (self-assessment procedure) in the case of controlled transactions with non-resident associated enterprises.

Arm's-length principle

Any commercial transactions including transactions or a series of transactions related to goods, rights, services or financial arrangements between a taxpayer and another entity with which it has special relations must be conducted as if they were independent entities carrying out comparable transactions.

The TP methodology adopted must ensure the best level of comparability between the tested transactions and the comparable data used to provide the benchmark. Factors affecting comparability include characteristics of the goods, rights or services, economic and financial environment, activities and functions performed, risks borne and assets employed.

The TP regulations also apply in cases of transactions between a non-resident entity and a PE in Portugal or between a PE of a non-resident entity with other PEs outside the Portuguese territory. The rules also apply to entities that are simultaneously exercising activities that are subject to CIT and activities that are exempt from CIT.

Associated enterprises

Special relations between two entities exist in case one entity has or may have, directly or indirectly, a significant influence in the management of the other entity. The law stipulates that a special relationship exists in the case of:

- an entity and its shareholders, or its relatives, which have directly or indirectly, a participation greater than, or equal to, 20% of the capital or the voting rights
- entities in which the same shareholders, or its relatives, have directly or indirectly, an interest greater than, or equal to, 20% of the capital or the voting rights
- an entity and the members, and their relatives, of its corporate bodies
- entities in which the majority of the members of its corporate bodies, or of any other administrative body, board of directors, or supervision or control, are the same persons, or being different persons are connected with each other by marriage, other (legal) forms of joint households, or by direct parental relation
- entities connected by a contract of subordination or other with equivalent effect
- entities that are in a control or domain relation, under the terms of Article 486 of Commercial Companies Code
- entities where one of the following relationships exist:
    - The activities of one entity substantially depend on industrial or intellectual property rights, or know-how owned and granted by the other entity.
    - The sourcing of raw materials, or the access to sales' channels of products, merchandise or services for one entity, substantially depends on the other entity.
    - A substantial part of the activity of one entity can be performed only with the other, or depends on decisions taken by the other entity.
    - The prices for goods or services rendered or acquired by one entity is, by provision set in juridical act, determined by the other entity.
    - Terms and conditions of commercial or juridical relations between the parties have the effect that one entity can influence the management decisions of the other entity in a way other than between two commercial parties acting at arm's length.
- an entity resident in Portugal, or a non-resident with a PE in Portugal and an entity resident in a territory considered by Portuguese law as a territory with a clearly more favourable tax regime.

These territories are listed in the Ministerial Order 150/2004, dated 13 February 2004, which has been altered by Ministerial Order 292/2011, dated 8 November 2011.

Transfer pricing methods
The methods to be used are:

- the comparable uncontrolled price (CUP) method
- the resale price method (RPM)
- the cost-plus method (CPM)
- the profit split method (PSM)
- the transactional net margin method (TNMM), and
- other methods when the methods mentioned above cannot be applied, or if these methods do not give a reliable measure of the terms that independent parties would apply.

Tax information and documentation
Every taxpayer shall indicate – in the annual declaration of accounting and fiscal information – an integral part of the annual CIT filings, the existence of transactions with associated enterprises.

The requested information includes the associated enterprises, the amount of the controlled transactions with each of the associated enterprises and an indication as to whether supporting documentation for the transfer prices was prepared at the time the transactions took place (and is still available).

Taxpayers with turnover of EUR 3 million or more should comply with the documentation requirements foreseen under the Portuguese legislation, namely the preparation of the TP file until the 15th day of the seventh month after the end of the fiscal year. The TP file must be available upon request by the tax authorities.

Corresponding adjustments
Where the TP provisions apply to controlled transactions between two entities that are both liable to Portuguese CIT, any adjustment to the taxable income of one should be reflected by a corresponding adjustment to the taxable income of the other. If a tax treaty is applicable, then the Portuguese tax authorities may also make corresponding adjustments through the competent authority procedure.

Other regulations
Ministerial Order 1446-C/2001 deals in more detail with the following issues:

- General rules on the arm's-length principle.
- Scope of application of TP rules.
- Adjustments to taxable income and corresponding adjustments.
- Transfer pricing methods and the best or most appropriate method.
- Factors determining comparability.
- Cost contribution arrangements (CCAs) and intragroup services.
- Relevant information and supporting documentation.
- Special provisions.

In addition, Article 23 of the Portuguese CIT Code considers that costs are deductible only if indispensable to generate or to guarantee profits subject to CIT.

However, non-documented costs or costs not complying with certain formal requirements are not deductible for CIT purposes. Furthermore, such costs are subject to an autonomous tax rate of 50%, even in the case of tax losses.

Burden of proof
Although under the recent TP rules, the taxpayer is required to have TP documentation available demonstrating compliance with the arm's-length principle, according to the General Tax Law the burden of proof lies with the entity that wishes to prove otherwise.

In fact, Article 77 of the General Tax Law foresees that the proof of non-compliance with the arm's-length principle lies with the tax authorities.

In the case of controlled transactions with non-resident associated enterprises, the taxpayer should include any necessary adjustments in its corporate income tax return in order to reflect arm's-length pricing (self-assessment).

Cost contribution arrangements (CCAs)
With respect to CCAs, the taxpayer must maintain the following documentation:

- Description of the participants and other associated enterprises involved in the activity covered by the agreement, or which are expected to exploit or use the results of that activity.
- The nature and type of activities carried out within the scope of the agreement.
- The method by which each participant's proportionate share in the expected advantages or benefits are determined.
- The accounting procedures and methods applied to allocate costs including the calculations made to determine each participant's contribution.
- The assumptions that underlie forecasts of expected benefits, frequency of review and forecasts of any adjustments arising from changes in the agreement, or in other facts.
- Expected duration of the agreement.
- Anticipated allocation of responsibilities and tasks under the agreement.
- Procedures for a participant entering or withdrawing from the agreement and conditions for the termination of the agreement.
- Penalty clauses.

Intragroup services
Regarding intragroup services' agreements, the taxpayer must maintain the following documentation:

- A copy of the agreement.
- A description of the services covered by the agreement.
- A description of the recipient of the services.
- A description of the costs of the services and the criteria applied for their allocation.

Thin capitalisation
The Portuguese thin capitalisation rules were abolished as from 1 January 2013 and replaced by specific limitations on the tax deductibility of interest expenses.

Net financing expenses are only deductible up to the higher of the following limits:

- EUR 1 million, or
- 30% of earnings before depreciations, net financing expenses and taxes.

Any exceeding financing expenses of a given tax year may be deductible in the following five tax years, after deducting the financing expenses of each year, provided that the above-mentioned limits are not exceeded.

Whenever net financing expenses do not exceed 30% of earnings before depreciations, net financing expenses and taxes, the unused part can be carried forward and increases the maximum deductible amount until the fifth following tax year.

A transitional regime is in place between 2013 and 2017 where the second limit is reduced over time from 70% (2013) to 30% (2017).

Penalties

In case the taxpayer does not deliver the TP documentation file within the deadline established by the tax authorities, the applicable penalty ranges from EUR 1,000 to EUR 10,000 (negligence).

In case a taxpayer refuses to deliver the TP file, upon request by the tax authorities, the applicable penalty may range from EUR 750 to EUR 150,000.

Late assessment interest (4% per year) is also charged. Neither penalties nor late assessment interest is deductible for tax purposes.

In case of the late payment of an additional tax assessment made by the tax authorities, interest for late payment will be applied (the interest rate is determined annually, in December, using the monthly average of the Euribor [Euro Interbank Offered Rate] at 12 months in the preceding 12 months, adding 5% – regarding 2015 the late assessment payment interest rate is 5.476% per year).

Documentation

Based on Ministerial Order 1446-C/2001, taxpayers are required to keep a TP documentation file, which is expected to include the following information:

- The terms and conditions agreed, accepted and observed in the open market in relation to the controlled transactions.
- The selection and application of the method or methods most appropriate for benchmarking transfer prices through the use of arm's-length comparables.

The TP documentation file should include the following information and documentation:

- A description of any special relations that exist with any entities with which commercial, financial or other transactions are carried out.
- A record of the corporate relationship by which the special relationship arose including any documents that demonstrate subordination, or dependency relationship as mentioned above.

- A description of the activities carried out during the controlled transactions, a detailed list of amounts recorded by the taxpayer over the past three years and, where appropriate, the financial statements of the associated enterprises.
- A detailed description of the goods, rights, or services involved in controlled transactions and of the terms and conditions agreed if such information is not disclosed in the respective agreements.
- A description of the activities performed, the assets used and the risks assumed, both by the taxpayer and the associated enterprises involved in the controlled transactions.
- Technical studies on essential areas of the business, namely investment, financing, research and development, marketing, restructuring and reorganisation of activities, as well as forecasts and budgets connected with the global business and business by division, or product.
- Guidelines regarding the TP policy of the company, containing instructions on the methods to be applied, procedures for gathering information (particularly on internal and external comparables), analysis of the comparability of transactions, cost accounting policies and profit margins obtained.
- Contracts and other legal instruments concluded with both associated enterprises and third parties, together with any other document that may govern or explain the terms, conditions and prices under those transactions.
- An explanation of the method, or methods applied to determine arm's-length prices for each controlled transaction and the rationale for the selection.
- Information regarding comparable data used (the grounds for selection, research records and sensitivity, and statistical analyses should all be documented).
- An overview of business strategies and policies, particularly regarding commercial and operational risks that might have a bearing on the determination of transfer prices or the allocation of profits or losses for the transactions.
- Any other information, data or documents considered relevant for determining an arm's-length price, the comparability of transactions or the adjustments made.

The taxpayer is expected to maintain the documentation for a period of 12 years after the filing of the tax return and to deliver the documentation to the tax authorities upon request. The documentation should help to verify the arm's-length nature of the transfer prices without the need for the taxpayer to incur excessive compliance costs.

The tax authorities have four years to raise additional CIT assessments. If tax losses were offset against tax profits within the above-mentioned period, the tax authorities may also audit the accounts of the years in which the tax losses were incurred.

Taxpayers are expected to update the prior-year documentation for transactions where the relevant facts and circumstances have changed to the extent that there is a material impact in the determination of the arm's-length price.

Transfer pricing controversy and dispute resolution

Legal cases

There have been few court cases on TP matters. More recent case law shows the importance of a well-prepared factual and functional analysis to support the arm's-length dealings with associated enterprises.

Tax audit procedures
The audit procedure can be either internal or external. During an internal audit, the taxpayer is requested to send documentation to the tax authorities for analysis; in an external audit, investigations are carried out at the taxpayer's premises. In the last case, documentation also may be requested from the taxpayer in order to be analysed at the tax authorities' premises.

Furthermore, the audit procedure can be either global or partial. A global tax audit reviews the entire tax status of the taxpayer, while a partial tax audit will focus on only one or more (but not all) of the taxpayer's tax duties. An audit may address more than one taxable period and/or more than one tax. The tax audit procedure must be concluded within six months. However, under certain circumstances, this period may be extended another six months (one year in total).

The audit procedure begins with a notification from the tax authorities to be signed by the selected taxpayer. This notification sets out the nature and scope of the audit, as well as the rights and obligations of the taxpayer during the audit process.

Audits are completed when the final tax audit report is delivered to the taxpayer. In case the tax auditor considers making tax adjustments, a preliminary tax audit report will be prepared by the tax auditor. This preliminary tax audit report is sent to the taxpayer, who has the opportunity to oppose, in all or in part, the conclusions of the report. After the objections have been heard, the tax auditor will issue a final tax audit report, which may give rise to an additional tax assessment.

Revised assessments and the appeals' procedure
Following a tax audit, the taxpayer is allowed to challenge the additional tax assessment raised by the tax authorities, either by means of an administrative claim submitted to the tax authorities, or via a judicial or arbitration appeal to the tax courts. An appeal against an additional tax assessment does not prevent the collection of additional tax. Therefore, the taxpayer should either pay the tax due, or provide a guarantee for its payment.

Resources available to the tax authorities
It is believed that the tax authorities have developed sufficient experience to deal with TP issues. Various TP audits have been performed and recently the tax authorities have started to make TP adjustments to the taxable profit of taxpayers.

Use and availability of comparable information
The taxpayer should select the TP method that assures the best grade of comparability between its transaction, or series of transactions and the uncontrolled benchmarking data. Where possible, the CUP method should be used to establish an arm's-length price, making use of available comparable price information.

There are several commercial databases available that contain (financial) information about Portuguese companies.

The tax authorities have been using information available from their own sources (i.e. information that is not publicly available, but obtained from CIT returns and governmental tax audits). The tax authorities use AMADEUS, a financial database, to assess the compliance of controlled transactions with the arm's-length principle.

In January 1999, the tax authorities published a list of ratios determined by dividing taxable income by turnover for the various sectors recognised for commercial register purposes. The ratios are based on taxpayer information for the years 1994, 1995 and 1996. Entities that in 1998 have a ratio that is inferior to the one determined for the relevant sector would, in principle, be subject to a tax inspection. We are not aware of such a study being repeated in later years. Furthermore, it is uncertain whether the tax authorities may use such data to support proposed adjustments to taxable income, because the underlying data may be considered confidential (secret comparables).

Risk transactions or industries
Transfer pricing is becoming an area of increasing focus for Portuguese tax authorities. They are notifying more and more companies to deliver the TP documentation of recent years. In our understanding, such companies are in different types of industries, and it does not follow that the tax authorities' TP audits are focusing on certain industries, or specific types of transaction. Therefore, as a general rule, all controlled transactions should be duly supported and documented in accordance with the arm's-length principle.

More recently, tax authorities have started to question the economic analyses presented in the TP documentation, among others by questioning the chosen profit level indicators and the criteria used in the benchmark searches. Moreover, we have experienced that tax authorities are asking for detailed information and documentation underlying intragroup services, such as management fees, royalties, CCAs, transactions with entities that are resident in low-tax jurisdictions and group financing.

Limitation of double taxation and competent authority proceedings
In principle, TP adjustments should be implemented so as to avoid double taxation.

When the adjustment is between two resident associated enterprises, it is mandatory that the tax authorities perform the corresponding adjustment.

When the adjustment affects transactions between a Portuguese company and a non-resident, the mechanisms laid down in the relevant double taxation treaty should be applied. Where the non-resident is within the European Union (EU), the provisions of the Arbitration Convention relating to the elimination of double taxation (EC Directive 90/436) may also be applied.

Advance pricing agreements (APAs)
Ministerial Order 1446-C/2001 stipulated that after relevant experience would have been gained regarding the application of the new TP rules, the Portuguese tax system would be in a position to adopt the Organisation for Economic Co-operation and Development's (OECD's) recommendations in the area of APAs. The state budget for 2008 introduced APA rules by means of adding Article 128-A to the CIT Code. This Article was subsequently changed into Article 138 by decree-law number 159/2009.

Article 138, Number 9 of the CIT Code stated that a Ministerial Order from the Minister of Finance would regulate the requirements and conditions for preparing and filing a request, as well as what procedures, information and documentation are to be applied in the APAs.

Detailed APA rules were introduced by Ministerial Order 620-A/2008, which entered into force on 16 July 2008.

This Ministerial Order establishes specific regulations regarding the implementation (procedures and obligations) of the APA regime in Portugal, namely:

- The APA request or proposal should be sent to the Portuguese Tax Authorities (PTA) up to 180 days prior to the beginning of the first fiscal year covered by the agreement.
- The maximum duration of an APA (duration from APA application to final conclusion) is 300 days for unilateral APAs and 480 days for bilateral and multilateral APAs, without considering delays attributable to the taxpayer regarding responses to the PTA's information requests.
- The conclusion of an advance agreement is subject to the payment of charges, which are determined under the terms and limits foreseen in Ministerial Order 923/99, dated 20 October 1999.
- The APA is valid for a maximum of three years with the possibility for renewal.
- Rollbacks are not available.

Due to the fact that Portugal only recently enacted legislation concerning APAs, it is effectively possible to obtain an APA only for the tax years starting on, or after, 1 January 2010.

Anticipated developments in law and practice

Recently, TP rules have also been extended to value-added tax (VAT) matters, in case one of the associated enterprises is not allowed to deduct all input VAT. It is not expected that there will be further developments in the near future.

Liaison with customs' authorities

Recently, the tax authorities and the customs' authorities merged in a single Tax and Customs Authority and, therefore, it is expected that there will be increasing exchange of information between tax authorities and customs' authorities.

Joint investigations

Portuguese law does not prevent Portuguese tax authorities from joining the equivalent body of another state to set up a joint investigation into a multinational company or group.

Comparison with OECD Guidelines

Portugal is a member of the OECD. The new TP rules reflect the approach set out by the OECD Guidelines. Ministerial Order 1446-C/2001 indicates that in more complex cases, it may be advisable to consult the OECD Guidelines for further clarification.

Under a reservation made in Article 9 of the Model Tax Convention on Income and Capital, Portugal reserves the right not to insert paragraph two (regarding corresponding adjustments) in its tax treaties. The 'older' tax treaties, most of them with EU countries, do not contain a corresponding adjustment provision. However, the more recent treaties include a corresponding tax adjustment provision equivalent to the above-mentioned paragraph of the Model Tax Convention on Income and Capital.

81.

Qatar

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Overview

The State of Qatar is unusual in that it has two tax regimes, both of which include transfer pricing (TP) provisions, one for the State of Qatar and one for Qatar Financial Centre (QFC). The Government of Qatar established an onshore financial centre, the QFC, in 2005, mainly aimed at regulated organisations operating in the financial services sector. However, the QFC law also permits certain other non-regulated activities to be carried out, such as accounting services, legal services, providing group treasury functions and acting as a holding company.

Country	**Qatar**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Should be ready upon examination.
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	N/A

Introduction

Qatar is an unusual country in the sense that it operates two tax regimes, QFC and Qatar State Tax Law tax law.

QFC
Under the new tax regime all QFC-registered companies are subject to corporate income tax at a flat rate of 10% on their local-source profits. Additionally, the new law introduces new concepts including a self-assessment regime, an advance ruling scheme and TP legislation.

Qatar State Tax Law
The Qatar State Tax Law does not contain a specific provision on TP; however, it includes a general anti-avoidance provision.

Legislation and guidance

QFC
Transfer pricing in QFC tax law is covered under Part 8, Articles (47–59). Part 8 provides rules for the treatment for tax purposes of income affected by transactions between 'associated persons'. Where transactions between associated persons are not on an arm's-length basis, and this results in a reduction in the amount of the chargeable profits of one of those associated persons, the QFC tax authority has the power to compute the taxable profits of an entity as if the arm's-length basis had been used for the transactions. An appeal can be lodged with the Regulatory Tribunal against such decisions.

Qatar State Tax Law
The Qatar State Tax Law, specifically Law No. 21 of 2009 does not contain detailed TP regulations and guidelines. However, there is an anti-avoidance provision under which it is deemed that if the taxpayer has entered into arrangements or has carried out operations or transactions, one of the main purposes of which is to avoid the payment of taxes due, the Tax Administration can take all or some of the following actions:

Apply the arm's-length value to the transaction, resulting in a different value than that established by the taxpayer.

Recharacterise the transaction if the nature of the transaction does not reflect its reality.

Adjust the amount of the tax due by the taxpayer or any other person involved in the arrangements, operations or transactions.

Penalties

QFC
Financial sanctions relating to returns, which are provided under the general tax provisions in Article (107), can be up to 100% of the tax understated. The specific penalty provisions state that:

"A QFC Entity which:

(a) Fraudulently or negligently files a return which is incorrect, or

(b) Discovers that a return filed by it, neither fraudulently or negligently, is incorrect and does not remedy the error without unreasonable delay, is liable to a tax-related financial sanction of an amount not exceeding the tax understated".

Documentation

QFC

QFC issued a TP manual (that only applies to QFC entities) that features non-binding guidance with respect to Qatar's TP regulations and rules. The new TP manual covers many areas including the basic rules on TP, intragroup financial transactions and the attribution of profits to permanent establishments.

The new TP manual clarifies that there are four types of records that need to be maintained by taxpayers including:

- Primary accounting records.
- Tax adjustment records.
- Records of transactions with associated businesses.
- Evidence to demonstrate arm's-length result.

The new TP manual states the use of the most appropriate of the five methods under the Organisation for Economic Co-operation and Development (OECD) Guidelines:

Traditional transaction methods:

- Comparable uncontrolled price (CUP) method.
- Resale price method.
- Cost plus method.

Transactional profit methods:

- Profit split method.
- Transactional net margin method.

Qatar State Tax Law

Arm's-length prices should be determined using the unrelated comparable pricing' (UCP) method. This method is essentially the same as the CUP method under the OECD Guidelines. If UCP is not applied, the taxpayer is required to obtain approval from the tax authority to use another approved OECD method.

The documentation for non-UCP pricing applications has yet to be confirmed.

Transfer pricing controversy and dispute resolution

QFC

The QFC tax law places the burden of proof on the taxpayer to produce sufficient TP documentation (and other supporting documents including inter-company agreements, schedules, and invoices) to support its declaration on the tax return.

Comparison with OECD Guidelines

The TP manual prepared by QFC tax authorities uses the five methods under the OECD Guidelines.

Qatar

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Romania

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Overview

The trend in transfer pricing (TP) developments in Romania reveals a growing interest of the Romanian tax authorities towards TP, which is one of the main areas of tax investigation. Under these circumstances, multinational companies are advised to pay close attention to the arm's length of their inter-company transactions and their documentation, so as to be prepared in case of any TP disputes with the tax authorities.

The TP audit activity has significantly increased, and requests for presenting the TP documentation file have become common practice.

In recent cases, the Romanian tax authorities adjusted the taxable result of taxpayers in accordance with the applicable regulations. The adjustments are carried out so that the profitability of the taxpayer reaches the median value of the arm's-length interval derived through a local benchmarking study. Most challenges and disputes generally arise in relation to the economic analysis.

Taxpayers should address with careful consideration the documentation of their inter-company transactions. Having appropriate TP documentation in place is, in all circumstances, a safeguard against non-compliance penalties and adverse tax consequences, which can result from TP adjustments.

Currently, the TP file should be presented upon request of the tax authorities during a tax audit. However, a draft legislation providing for annual mandatory filing of the TP documentation is currently in discussion at the tax authorities' level.

Country	**Romania**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes

Romania

Country	Romania
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	At the request of Romanian tax authorities
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the adjustment to taxable income

Introduction

The Romanian TP legislation follows the Organisation for Economic Co-Operation and Development (OECD) Guidelines and requires that transactions between related parties be carried out at market value. In case transfer prices are not set at arm's length, the Romanian tax authorities have the right to adjust the taxpayers' revenue and expenses so as to reflect the market value. Profit adjustments on transactions between related parties can be performed within the domestic statute limitation period (i.e. six years).

Legislation and guidance

Statutory rules

The arm's-length principle was first introduced in domestic tax law in 1994. An important milestone in the development of the TP legislative framework occurred in 2004, upon the introduction of the Fiscal Code, which set out in a systematic manner the definition of related parties, the statement of the arm's-length principle and the methods for setting transfer prices at arm's length.

The Fiscal Code norms detail the scope and the application of TP rules. Although Romania is not a member of the OECD, these norms expressly stipulate that in the application of TP rules, the Romanian tax authorities will also consider the OECD Guidelines.

The arm's-length principle

The arm's-length principle is applicable to all inter-company transactions including those between a foreign legal entity and its Romanian permanent establishment. Beginning with 2010, inter-company transactions carried out between two Romanian legal entities also fall within the scope of TP investigations, whereas previously, only transactions with non-resident-related parties were scrutinised by the tax authorities.

Definition of related parties

Two legal entities are related parties, provided that:

- one entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the other entity, or it effectively controls the other entity, and
- one entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares, or voting rights in the two entities.

An individual is a related party with a legal entity provided that they hold directly or indirectly including the shareholding of related entities, a minimum of 25% of the number/value of shares or voting rights in the legal entity, or it effectively controls the legal entity (unfortunately the legislation is silent on the meaning of 'effective control').

Two individuals are related parties provided that they are spouses or relatives up to the third degree.

Transfer pricing methods

Local legislation provides that taxpayers may use traditional TP methods (comparable uncontrolled price [CUP], cost plus [CP] and resale price), as well as any other method that is in line with the OECD Guidelines (transactional net margin and profit split). If the CUP or a traditional TP method is not used, the taxpayer should set out in the documentation the reasons for not doing so.

Taxpayers should consider the following main criteria when selecting the most adequate TP method:

- Activities carried out by the related parties.
- Availability of data and justifying documents.
- Accuracy of adjustments to meet comparability criteria.
- Circumstances of the specific case (e.g. characteristics of the tangible goods transferred, stage within the supply chain, payment conditions, guarantees, discounts).

For specific types of transactions, guidance is provided on the application of TP methods and the comparability factors that should be considered by the taxpayer.

- Provision of services – the arm's-length transfer price should be set using the CUP method, by considering the usual fees for each type of activity or the standard rates in certain fields. In the absence of comparable transactions, the CP method should be used.
- Inter-company loans – the arm's-length transfer price is represented by the interest that would have been agreed upon between third parties in comparable circumstances including the commission for handling the loan. Comparability factors that should be considered in assessing the arm's-length interest rate include: amount and duration of the loan, nature and purpose of the loan, currency and foreign-exchange risk, existence of guarantees, costs of hedging the foreign exchange risk, etc.

Advance pricing agreements (APAs)
In Romania, taxpayers engaged in related-party transactions have the opportunity to apply for APAs. Details regarding the application procedure and the documentation that needs to be prepared by a taxpayer intending to request an APA are provided in a Government decision, issued in June 2007.

The APA is defined as an administrative act issued by the National Agency for Tax Administration to address a taxpayer's request in relation to establishing the conditions and methodology to set transfer prices in related-party transactions for a fixed period of time.

The procedure is initiated by the taxpayer through submission of a request for an APA, which can be preceded, if desired by the taxpayer, by a pre-filing meeting. The documentation that needs to be provided, upon request, for an APA is similar to the TP documentation file and needs to include upfront the content of the APA.

The APA can be issued for a period of up to five years and is generally valid, starting from the fiscal year, subsequent to the filing of the request. By exception, its validity may be longer in case of long-term agreements. The APA is opposable and binding on the tax authorities as long as its terms and conditions are observed. In this view, taxpayers need to submit an annual report on these terms and conditions by the deadline for submitting the statutory financial statements.

If the taxpayer does not agree with the APA, a notification may be sent to the issuing tax authority within 15 days from the communication date, and the APA would no longer have a legal effect.

The deadline for issuing APAs is 12 months for unilateral and 18 months for bilateral or multilateral APAs. In case of large taxpayers and for transactions with an annual value exceeding 4 million euros (EUR), the fee for issuing an APA is EUR 20,000, and the fee for amending it is EUR 15,000. For the rest of the taxpayers, the fee for issuing an APA is EUR 10,000, and the fee for amending it is EUR 6,000.

Starting 1 January 2014, large taxpayers comprise the first 2,500 legal entities listed in descending order using the following criteria: the amount of tax due, the turnover of the foregoing financial year, the activity performed (i.e. banking, insurance, financial investments) and investments made. In 2015, the criteria on amount of tax due and the turnover of the foregoing year were suspended upon annual reconsideration of the list of large taxpayers.

Comparable information
The detailed regulations regarding the content of the local TP documentation file include specific provisions on the procedure to conduct benchmarking studies. These should include local comparables. European or international benchmarking studies are accepted, provided that there are no local comparables or if the set of local comparables is too limited.

Another particularity of the way to carry out the benchmarking study is that the comparability range is narrowed to the interquartile interval. If the taxpayer's transfer prices fall outside the comparability range, the adjustment shall be carried out to the median.

In Romania, information on the performance of companies is available, only in the form of published annual financial statements. These statements contain information that can enable computation of various profit level indicators. However, in some cases, segregation of transactions and identification of the cost base may prove to be difficult, due to the particularities of the Romanian accounting system.

Penalties

Failure to present the TP documentation file may result in fines ranging from 12,000 Romanian lei (RON) to RON 14,000 (i.e. approx. EUR 2,800 to EUR 3,300 at the current foreign-exchange rate) and estimation of transfer prices by the tax authorities, based on generally available information on similar transactions, as the arithmetic mean of prices on three similar transactions.

The additional taxable profits resulting from this estimation or any TP adjustments are subject to the general 16% profit tax rate and related late payment interest and penalties. Under Romanian legislation, late payment interest and penalties are tax non-deductible.

Documentation

In line with the fiscal procedure code, taxpayers engaged in inter-company transactions are required to prepare a TP documentation file that needs to be presented, upon request of the tax authorities, during a tax audit. The deadline is to be set at a maximum three months from the date of receiving the formal written request, with the possibility of a single extension with a period equal to the term initially established.

In February 2008, detailed regulations regarding the content of the local TP documentation file were published. The content of this file is in line with the Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD).

There is currently no minimum threshold for documenting controlled transactions or any simplified documentation rules and, therefore, irrespective of materiality, Romanian tax authorities can scrutinise the arm's-length nature of any controlled transaction.

Starting 1 January 2016, contemporaneous TP documentation requirements are expected to be introduced under the Romanian legislation.

Transfer pricing controversy and dispute resolution

Tax audits

The Romanian tax authorities should first assess the arm's-length character of the controlled transaction by using the method applied by the taxpayer. However, in case the tax audit reveals that the arm's-length principle is not observed, the Romanian tax authorities may apply the method they consider as most appropriate.

Burden of proof

In Romania, the burden of proof lies with the taxpayer, who should prepare TP documentation in order to defend the arm's-length nature of its transfer prices. In the case of litigation, however, the burden of proof may shift to the tax authorities in order to demonstrate that the transfer prices set by the taxpayer are not at arm's length.

Other aspects

Inter-company loans

In case of related-party financing, the following should be analysed:

- Whether the loan granted serves the business interest of the beneficiary and has been used for that purpose.
- Whether there has been a profit distribution scheme.

Requalification of an inter-company loan into a profit distribution scheme occurs if, at the moment of granting the loan, a reimbursement is not expected and the agreement includes unfavourable conditions for the borrower. Under these circumstances, the loan can be reclassified as share capital. The deductibility of interest expenses and any foreign-exchange differences can be challenged, and they can be assimilated to dividend payments.

Under the Romanian Fiscal Code, interest expenses incurred in relation to inter-company loans having a maturity that exceeds one year are subject to the following two limitations:

- Safe harbour rules

Interest expenses on these inter-company loans are deductible within the following limits:

- In the case of loans denominated in hard currency (any other currency than the local currency), a ceiling established annually through government decision (i.e. 6%).
- In case of loans denominated in local currency, the reference interest rate of the National Bank of Romania.

The particularity of these 'safe harbour' rules is that taxpayers are not exonerated from their documentation obligations.

Interest expenses exceeding these limits are non-deductible and cannot be carried forward to subsequent years. This limitation is applied separately to each inter-company loan before considering the thin capitalisation rules detailed below.

- Thin capitalisation rules

Interest expenses on inter-company loans are deductible, provided that the debt to equity (D/E) ratio is lower than or equal to three. In case the D/E ratio is negative or higher than three, interest expenses are non-deductible in the current year and can be carried forward to subsequent years.

The D/E ratio is determined as a ratio between the company's related-party liabilities with a maturity exceeding one year (including liabilities whose maturity was extended so that it exceeds one year) and the owner's equity, by considering the average of the book values recorded at the beginning and at the end of the year.

In particular, expenses with foreign-exchange differences also need to be considered. Therefore, in case expenses with foreign-exchange differences exceed revenue from foreign-exchange differences, the difference is treated as interest expense and is subject to the limitation mentioned above. The expenses with foreign-exchange differences subject to this limitation are those related to the liabilities considered for determining the D/E ratio.

This limitation is not applicable to banks, Romanian legal entities or branches of foreign banks, leasing companies for their leasing operations, real estate mortgage companies, credit institutions and non-banking financial institutions.

Liaison with customs' authorities
The tax and customs' authorities in Romania do not usually cooperate when it comes to TP issues. The majority of customs' value investigations to date have been related to the adjustment of the customs' value according to Article 8 of the WTO Customs Valuation Agreement. Issues including the adjustment of customs' value for royalties, licence fees, assists (e.g. packaging design, tools), and the inclusion of transport expenses were among the favourites of the customs' inspectors.

However, we expect that TP adjustments, although not automatically notified to the customs' authorities, will lead to further investigations and adjustments in customs as a result of the exchange of information between tax and customs' authorities or as a result of their reflection in the business transactions.

Comparison with OECD Guidelines

As noted in the Introduction section above, the Romanian TP legislation follows the OECD Guidelines. More specifically, the local legislation expressly stipulates that the local TP rules are to be supplemented by the OECD Guidelines. Therefore, the local TP legislation does not diverge from the OECD Guidelines.

Romania

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Russian Federation

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Overview

New Russian transfer pricing (TP) rules have been in place since 1 January 2012. Russia is not a member of the Organisation of Economic Co-operation and Development (OECD); consequently, principles established by the OECD TP Guidelines are applicable in Russia, only in part, which does not contradict the Russian Tax Code provisions on control over pricing for tax purposes. The transition period of 2012–2013 granted to taxpayers to tailor their operations to requirements of the new TP rules is over on 1 January 2014. That means that going forward, Russian tax authorities will start applying the TP rules more actively and, more and more taxpayers doing business in Russia may face a TP audit.

Country	**Russia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	By 1 June of year following reporting one
Must TP documentation be prepared in the official/local language?	Yes (in Russian)
Are related-party transactions required to be disclosed on the tax return?	Yes (Notification on controlled transactions)
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes, if tax is underpaid
Do penalties or fines or both apply to branches of foreign companies?	Yes – applied to branches if tax is underpaid
How are penalties calculated?	20% of underpaid tax (40% – from 2017)

Russian Federation

Introduction

The new Russian TP rules became effective from 1 January 2012. The new rules aim to make Russian TP rules work in practice and bring them closer to the OECD TP Guidelines. The current Russian TP rules give the tax authorities more information about the transfer prices applied and methods used in intragroup transactions (by introducing TP reporting and documentation requirements). In addition, the current TP rules introduced provisions regarding advance pricing agreements (APAs) available for the largest taxpayers.

The following briefly summarises the new Russian TP rules, which apply from 2012.

Legislation and guidance

Controlled transactions

The current Russian TP rules cover the following types of controlled transactions:

- Domestic transactions between related parties (*see below*) if they meet one of the following criteria:
  - The amount of transactions exceeds 1 billion Russian rubles (RUB) (approx. 17 million United States dollars [USD] per calendar year.

  Transactions concluded between Russian taxpayers registered in the same administrative region, which do not have any subdivisions in other administrative regions within Russia or abroad are exempt from TP control (provided none of these taxpayers has tax losses). In addition, transactions concluded between members of the same consolidated group of taxpayers will also be exempt from TP control.
- Certain types of transactions which meet at least one of the following conditions and whose aggregate income exceeds RUB 60 million per calendar year (approx. USD 1 million):
  - If one party to a transaction is subject to mineral extraction tax and the goods are subject to the above tax at a percentage rate based on sales price.
  - One party to a transaction is exempt from profits' tax or applies 0% tax rate, while the other party is a profits' taxpayer in Russia and does not apply 0% tax rate.
  - One party to a transaction is resident in a special economic zone, while the other is not resident in that special economic zone; these provisions are effective from 1 January 2014.
- Transactions where one party applies the unified agricultural tax or a unified imputed income tax (regarding certain types of activities), while the other party pays profits' tax under general rules. Such transactions are subject to control starting from 1 January 2014 if the aggregate income (prices) exceeds RUB 100 million per calendar year (approx. USD 1.7 million).
- Cross-border transactions between related parties; under a general rule, no threshold is established for such transactions.
- Cross-border transactions with certain types of commodities: (i) oil and oil products; (ii) ferrous and nonferrous metals; (iii) fertilisers; and (iv) precious metals and stones. The list of commodities is established by the Russian Ministry of Industry and Trade. A financial threshold of RUB 60 million per calendar year is established for such transactions (approx. USD 1.3 million).

- Transactions with parties incorporated (domiciled, tax-resident) in a state or territory included in the Finance Ministry's list of offshore zones that grant beneficial tax regimes and do not share information during financial audits (a financial threshold of RUB 60 million per calendar year applies). The list of such territories is approved by the Russian Ministry of Finance for the purposes of applying a participation exemption on dividends. The list includes such jurisdictions as the British Virgin Islands, Hong Kong, Gibraltar, Liechtenstein and certain other territories.

For the purposes of financial threshold calculation, taxpayers should add up the value of all transactions with a particular counterparty during one calendar year.

According to the new rules, if prices are regulated by the Russian authorities or established in accordance with Russian anti-monopoly law, the Russian tax authorities should accept such prices for TP purposes.

To conclude, the current Russian TP rules are, to a certain extent, aligned with the OECD TP principles, whose pricing controls focus solely on transactions between related parties. Nevertheless, by including cross-border transactions involving certain types of commodities and transactions with residents of low-tax jurisdictions in the list of controlled transactions, the tax authorities have in effect incorporated certain elements of anti-avoidance rules in the current Russian TP rules.

Interdependent parties
Under the new rules, the following parties are recognised as being related under the Tax Code:

- Entities where one party (the party and its related parties) has more than a 25% direct or indirect participation in these entities.
- Entities where (i) more than 50% of the directors of these companies are the same individuals, or (ii) not less than 50% of the directors are appointed/chosen by the same individual.
- Entities, where the same individual/entity acts as the sole executive body; and on the basis of some other criteria.

Courts also have the right to recognise parties related for reasons other than those stipulated in the Tax Code if the relationship between the parties may have an impact on the conditions and outcome of a transaction performed by these parties or the results of their economic activity.

Economic interdependence of the parties to a transaction, arising, for instance, due to one party's dominant market position, is not to be used as grounds for declaring that the parties are related.

Basis for transfer pricing adjustment
The Russian tax authorities are allowed to make TP adjustments in relation to: (i) corporate profits tax; (ii) individual income tax (for individual entrepreneurs only); (iii) mineral extraction tax (if goods are subject to the above tax at a percentage rate); and (iv) VAT (if the counterparty is exempt from Russian VAT or is not a VAT taxpayer in Russia).

The new rules introduced the concept of a market price (profitability) range (i.e. effectively the concept of interquartile range of prices or profit level indicators). The tax authorities are entitled to adjust prices for tax purposes if the price applied in a controlled transaction or its profitability is not within the determined market range of prices (profitability).

The formula of the market range under Russian TP rules is slightly different from the interquartile range formula traditionally applied by OECD member countries to determine market prices. Moreover, when determining the market profitability range on the basis of the financial data of comparable independent companies, the new rules establish a number of specific criteria (e.g. constantly loss-making companies should be excluded, or companies with negative assets) to be followed for selecting such comparable companies.

The new rules have introduced a correlative adjustment mechanism for Russian companies in order to avoid double taxation with respect to domestic transactions. Provided that the tax authorities adjust the tax base of a Russian taxpayer and the latter pays the tax, the other party to the controlled transaction – a Russian company – will be entitled to claim a corresponding adjustment to its tax base. The wording contained in the TP rules refers to correlative adjustments relating to Russian domestic transactions only. Furthermore, recently amendments to the rules were introduced, allowing correlative adjustments if they result from self-adjustment by one of the counterparties.

Some Russian tax treaties provide for correlative adjustment provisions in respect of cross-border transactions. However, in practice, we have not come across such occasions where the Russian tax authorities have applied TP treaty protection for TP cases.

Transfer pricing methods

The TP methods are as follows:

- Comparable uncontrolled price (CUP) method.
- Resale price method.
- Cost plus method.
- Transactional net margin (comparable profits method).
- Profit split method (PSM).

The rules contain the best-method rule, coupled with a certain hierarchy in the methods' application. The CUP method remains the primary TP method to be used over all other methods (except for a case when a company purchases goods from a related party and resells them to independent parties; in this case, the resale minus method is given priority). If the CUP and resale minus methods are not applicable, the taxpayer is free to choose between the remaining methods, although the PSM should be used as 'the method of the last resort'. The choice of a particular TP method should be supported with due consideration of the functions performed, the commercial (economic) risks assumed and the assets employed in a controlled transaction. It is also possible to establish the transaction price/value by use of an independent appraisal, in the case of one-off transactions when none of the above TP methods can be applied.

The new rules contain quite brief provisions on application of the TP methods. However, given that the Tax Code does contain guidance in relation to which comparability factors are important for a particular TP method, disputes with the Russian tax authorities may arise in relation to the choice of a TP method. The new rules allow taxpayers to make self-maintained adjustments of tax amounts at the end the calendar year if the prices used in a controlled transaction between related parties are not at arm's length. Such adjustments can be made only if tax liabilities were understated. Self-determined adjustments to decrease the taxable base are not allowed.

Safe harbours
The new rules extend the list of comparability factors to be considered during the TP analysis; in particular, the company's functional and risk profile and business strategy will be introduced as comparability factors. However, there are no special safe harbours in the new rules (the old law which was effective before 1 January 2012 allowed 20% deviations from the market price).

Securities and derivatives
The Profits Tax chapter of Part II of the Tax Code came into force on 1 January 2002 and introduced special TP rules for securities and derivatives. At the end of 2009, the Russian Parliament passed Federal Law No. 281-FZ of 25 November 2009, which introduced a number of important changes to the tax treatment of securities and derivatives. The rules establish the conditions that should be met so that the actual price of a transaction is deemed to be the market price and therefore may be used as a basis for the calculation of taxes by the tax authorities.

Thin capitalisation
The Profits Tax chapter of Part II of the Tax Code, which entered into force on 1 January 2002, introduced thin capitalisation rules on debts between interdependent parties. These rules apply when the loans due to a foreign entity by a Russian entity that is more than 20% owned by this foreign entity or its affiliated parties exceeds by more than three times (or 12.5 times in the case of banks/credit institutions or enterprises engaged in leasing) the own capital of the Russian entity. These rules also apply to loans received from third parties if such loans are guaranteed by the above foreign company or its Russian affiliates. Such loans are determined in the tax legislation as controlled debts.

If the above conditions are met, the maximum deductible interest would be determined by the ratio of the interest accrued on the 'controlled debt' to a capitalisation coefficient (a ratio of the controlled debt multiplied by a percentage of the direct or indirect shareholding to the Russian entity's own capital multiplied by three [or 12.5 in the case of banks/credit institutions or enterprises engaged in leasing]). Interest in excess of the maximum interest is treated as dividends that are non-deductible for profits tax purposes and are subject to withholding tax.

In addition to restrictions imposed by thin capitalisation rules (if any), the general requirements on the deductibility of interest should be observed. Generally, interest incurred by an entity should be deductible for Russian profits tax purposes, provided such interest expenses meet the general deductibility criteria (i.e. they are economically justified, documentarily supported and relate to the taxpayers profit-generating activity) and falls within the safe harbour range established by the Tax Code.

At the same time, Russian tax legislation establishes certain limitations in respect of the level of interest deductible for tax purposes.

The Russian tax authorities have expressed their position that the new TP rules apply to loans and guarantees. Therefore, both TP rules and interest deduction limits should be considered for determining deductible interest expense.

Other regulations

On 12 January 2012 the Russian tax authorities issued special regulations on Advance Pricing Agreements; on 27 July 2012 – regulations on preparation of notifications on controlled transactions; and on 30 August 2012 – regulations on preparation of TP documentation.

There are a number of unofficial clarifications on the application of the new TP rules issued by the Russian Ministry of Finance/Federal Tax Service (e.g. clarifications on how to calculate the financial threshold, interdependence of parties for TP purposes and many other technical aspects of application of the new rules).

Use and availability of comparable information

The new TP rules have introduced an open list of information sources that can be used to establish the market price range. These sources include international exchange quotations, statistical data of Russian customs' authorities and pricing information available from authorised state government bodies, or publicly available information systems. Information from financial statements of foreign companies can be applied to determine an arm's-length profitability range for a Russian company, only if the respective ranges cannot be calculated; based on the Russian comparable data, the taxpayer will be required to present some proof of benchmarking studies being done, using Russian comparables prior to being entitled to more foreign data. To analyse Russian company's profitability, Russian generally accepted accounting principles (GAAP) data should be used.

Tax audit procedures

Under the new rules, special TP audits are performed by the TP Unit of the Federal Tax Service (FTS).

The TP audit-related rules will be enforced according to the following timetable:

- For transactions completed in FY12, they can be initiated only until 31 December 2013. If no TP audit was initiated for 2012, this year is now closed for a TP audit.
- For transactions completed in FY13, they can be initiated only until 31 December 2015.
- The standard three-year period available for TP audits applies only from 1 January 2014.

During TP audits, the Russian tax authorities have the right to request information from both parties of a controlled transaction. Under ordinary circumstances a TP audit should last no longer than six months, but in certain cases, it can be extended up to 21 months (e.g. extensions may be necessary if information from foreign tax authorities is requested or there is a need to involve an expert, etc.).

Liaison with customs' authorities
As noted above, the Russian tax authorities may cooperate with the customs' authorities in determining comparables. Russian customs' authorities possess certain databases containing comparable prices and have certain techniques for evaluating customs' value of goods. These databases and techniques may be used by the tax authorities when challenging prices in controlled transactions. Moreover, the tax authorities will work in close cooperation with the customs' authorities on auditing prices set in foreign trade transactions. However, it is to some extent unclear whether information provided by the customs' authorities would satisfy strict comparability requirements established for TP purposes.

Note that taxes payable on import of goods to Russia (import VAT and customs' duties) are calculated on the basis of the customs' value determined by applying special rules contained in Russian customs' legislation as opposed to the general TP rules contained in the Tax Code. The customs' pricing rules provide for six methods of determining customs' value of goods and contain a much wider definition of related parties than that which is established in the Russian Tax Code for TP purposes.

Penalties
Russian tax authorities may charge additional tax and late payment interest on underpaid tax. Late payment interest should be charged in accordance with the general rules at a rate of 1/300 of the Central Bank of Russia refinancing rate (e.g. on 1 October 2014 this rate is set as 8.25% per year).

Penalties of up to 40% of underpaid tax are assessed as a result of applying prices that do not comply with the arm's-length principle. Such penalties apply in the event of non-submission or submission of incomplete, untimely or inaccurate TP documentation. The new rules provide for a transition period, in particular, a lower penalty of 20% of underpaid tax applies for tax assessments for 2014–2016 tax periods.

The untimely submission of a TP notification form, or its inaccurate completion, may result in a penalty of RUB 5,000 (approximately USD 83).

There may be a criminal liability charged to the general director and the chief accountant of a Russian entity for underpayment of taxes in significant amounts (including underpayment of taxes due to use of prices that do not correspond to the market).

Documentation
Documentation requirements
The new rules have formally introduced TP documentation requirements and provide that the tax authorities may request TP documentation during a TP audit, but not earlier than by 1 June of the calendar year following the year in which a controlled transaction was performed. Taxpayers will be required to present TP documentation within 30 working days of receiving a tax authority's request. Given the requirements set by the Russian Tax Code with respect to the TP documentation, it is not possible to prepare a proper TP documentation within the above period; therefore, it is better to do it in advance. Documentation should contain the following information:

- Description, nature and terms of a controlled transaction.

- Functional analysis: assets employed, functions performed, risks assumed by each party to the controlled transaction (although it is listed as an optional element, it is strongly recommended to include functional analysis in order to support the choice of the TP method). In the clarification letters, Russian tax authorities expect the functional analysis to contain references to legal contracts as a support for functions performed, risks incurred.
- TP method(s) used.
- Description of comparables: sources of information and other data used and calculating the range of the arm's-length prices/profitability.
- Financial analysis: calculations showing how the method has resulted in arm's-length terms, calculation of income (profit) to be received, and economic benefits obtained as a result of the controlled transaction (for transactions with IP rights).

For the purpose of applying TP documentation requirements, the threshold on income and expenses from controlled transactions is the same as for reporting requirements (TP notification form).

Russia's FTS has published Letter No. [illegible]-4-13/14433 of 30 August 2012 (the Letter) on preparing and filing documents for tax control purposes. The Letter explains the rules governing preparation of TP documentation, specifically which transactions require documentation, level of detail, filing deadlines, archiving period and other related information. The Letter contains two appendices. The first appendix recommends the content of the documentation, while the second recommends stages to be followed in preparing the relevant documents.

The Letter also says that a taxpayer's document filings will be used for conducting a pre-audit review and selecting a taxpayer to undergo tax control measures. This could imply that the tax authorities are planning to request TP documentation before commencing a TP audit. According to the Letter, economic analysis findings (i.e. a benchmarking study) should be fully revised annually rather than updated (in other words the new study should be done with new downloads from the relevant databases to include information about new comparable companies in the marketplace, which may have emerged during the year, have a comparable profile and were not included in earlier samples).

In cases where taxpayers have complied with the above procedure in a timely manner, the tax authorities will release taxpayers from the penalty in the event of a TP assessment. In these circumstances, taxpayers will have to pay tax calculated in addition to what they have already paid, plus late payment interest, but not the penalty.

Reporting requirements

The new rules have introduced reporting requirements for taxpayers, who are required to submit certain information on controlled transactions not later than 20 May of the calendar year following the year when a controlled transaction was performed.

Such reporting requirements apply, provided the amount of controlled transactions concluded with the same entity exceeds the threshold of RUB 100 million (approx. USD 1.6 million) in 2012 calendar year. The above threshold gradually decreased to RUB 80 million (approx. USD 1.3 million) in 2013 and to nil in 2014. By decreasing the threshold, the authorities anticipate covering a wider range of transactions in terms of reporting requirements.

The notification form includes the following sections:

- Information about the transaction including the amount of income derived and expenses incurred (disclosure of the pricing method and information sources used is optional).
- Information about the subject of the transaction including the relevant contract number, the amount and the price, as well as delivery terms.
- Information about the company/individual that is a party to the transaction.

The scope of information to be disclosed in the notification form is quite substantial. The tax authorities treat transaction as each separate operation, e.g. each delivery of goods under different deliver terms is a separate transaction. Consequently, filling in the notification form usually involves significant administrative efforts and resources. The notification form should be submitted using a special software program developed by the FTS.

On 27 July 2012, detailed regulations on completion of the notification form were issued by the tax authorities.

Transfer pricing controversy and dispute resolution

Burden of proof

In the new rules, the burden of proof that the prices of controlled transactions do not correspond to market prices formally rests with the Russian tax authorities. However, during a tax audit the tax authorities are well-equipped, since formal reporting and TP documentation requirements are introduced; in addition, the tax authorities may outline certain arguments why they believe that the applied prices are not at arm's length and then it becomes the responsibility of the taxpayer to prove otherwise.

Advance pricing agreements

Under the current rules, only a selected group of taxpayers (the largest taxpayers) are given an opportunity to conclude advance pricing agreements (APAs). An APA represents an agreement between a taxpayer and the federal executive body responsible for control and supervision in the area of taxation (the FTS).

On 12 January 2012, the Russian tax authorities issued special regulations on APAs. The term of the APA should not exceed three years, with the right being given to taxpayers to apply for an extension of up to two years, provided that all of the APA's terms and conditions are being fulfilled by the taxpayer. The APA application fee is USD 50,000. As of the beginning of 2015 the FTS has concluded 24 APAs.

Legal cases

Although case law does not exist in Russia, the vagueness of tax laws and the inconsistency that exists between the law and its broad interpretation by the tax authorities means that the courts play a vital role in developing tax law interpretations in Russia. That is, in particular cases the law is construed by the decisions of various courts. However, for the reasons discussed, these decisions often serve only as a general guide in disputes between the tax authorities and taxpayers, where situations are similar.

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An analysis of current Russian arbitration court practice in relation to TP cases shows that hot topics inter alia include:

- Challenging losses of Russian distributors of multinational companies or corporations.
- Deduction of inter-company management charges.
- Export sales at prices lower than prices for domestic market.
- Trademark royalty deduction.
- Use of European comparables from the foreign database to support profit attribution to a permanent establishment.
- Interest charged to daughter companies at below cost of attracting financing.
- Sale of goods through intermediary companies with no substance.
- Understatement of lease payments between related parties.

Limitation of double taxation and competent authority proceedings
Russia is a party to around 80 double tax agreements, most of which have been concluded on the basis of the OECD model (although often with significant deviations) and therefore contain the 'Associated Enterprises' (or 'Adjustment of Profits') article. This article provides for correlative adjustments in the majority of the agreements (although primarily those concluded recently). In the older treaties, this article provided for a one-way adjustment that increases the profit of a treaty resident due to the use of non-market prices.

Very little information is available on the practice and procedure for invoking competent authority assistance (as no such information is public). The opportunity to get a refund theoretically exists, as according to informal interviews with Russian Ministry of Finance representatives, there are some cases when the mutual agreement procedure (MAP) has been initiated (e.g. cases related to withholding tax application/personal income tax refunds); however, no timeframe is established for the Ministry of Finance to perform MAPs; therefore, the outcome of such discussions could not be reasonably predicted.

Comparison with OECD Guidelines

Russia is not a member of the OECD, but it is influenced by OECD Guidelines and models. Currently, Russia has an observer status in some OECD committees. Therefore, OECD TP Guidelines are applicable in Russia only in a part that does not contradict the Russian Tax Code.

Due to political reasons in April 2014, the Russian Ministry of Finance and OECD officials stopped negotiations on Russia's entering OECD as a member country.

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Saudi Arabia, Kingdom of

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Overview

There are no specific transfer pricing (TP) rules in the Kingdom of Saudi Arabia (KSA); however, the KSA tax law explicitly states that transactions between related parties should be conducted, based upon the arm's-length principle. The corporate tax rate in the KSA is 20% of the net adjusted profits.

Based on a recent Ministerial Resolution issued by the authorities in March 2014, an addition to Article (10) paragraph (11) of the Saudi Tax By-Laws provides for "The Department of Zakat and Income Tax (DZIT) to issue the regulations on transfer pricing of transactions between related parties in accordance with the internationally accepted standards". Based on this update, we understand that the Saudi authorities would soon be issuing specific TP regulations in the KSA.

Country	**Kingdom of Saudi Arabia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No, but documentation should be prepared.
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	No statutory requirement
Must TP documentation be prepared in the official/local language?	Arabic
Are related-party transactions required to be disclosed on the tax return?	Yes

Saudi Arabia, Kingdom of

Country	Kingdom of Saudi Arabia
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	No penalties

Introduction

There is currently no specific and detailed TP regulations and guidelines in the KSA; however, the KSA tax law stipulates that related-party transactions are conducted on an arm's-length basis. This provision in the tax law allows the DZIT to reallocate revenues and expenses in transactions between related parties, so as to reflect the returns that would have resulted if the parties were independent or unrelated.

Even though the Saudi Tax Law refers to transactions between independent persons to be arm's length, there is no real guidance on what would constitute an 'arm's-length' price. The onus is therefore on the parties (and in particular, the Saudi taxpayer) to be able to demonstrate and prove that transactions are on arm's-length principles. Failure to do so could result in the DZIT reallocating income so that, effectively, the Saudi entity could be subject to income tax on an amount which is higher than actual income reported in its hands as a result of transactions between associated entities and itself.

Based on the above, entities that have substantial losses or periods of sustained losses, usually come under greater scrutiny by the DZIT.

Legislation and guidance

The KSA tax law contains no detailed TP rules or guidelines. However, transactions between related parties and the arm's-length principle are explicitly addressed in the law. More specifically, Article 63(c) provides that the DZIT may reallocate revenues and expenses in transactions between related parties to reflect the returns that would have resulted if the parties were independent or unrelated. Furthermore, Article 64 defines related parties and Article 58 requires taxpayers to maintain documentation (in Arabic) to support the 'precise determination of tax payable by it'. Moreover, Article 61 provides the DZIT with the authority to examine a taxpayer's records. Taken together, these articles provide the DZIT with the authority to request underlying documentation and to make income adjustments, based on the arm's-length principle, whereby the DZIT's arm's-length test may differ significantly from Organisation for Economic Co-operation and Development (OECD) standards. Payments for goods or services delivered to the taxpayer by related parties to the extent that it is in excess of an arm's-length value is considered non-deductible from a KSA perspective.

Penalties

There are currently no specific TP penalties in the KSA.

Documentation

Taxpayers are required to maintain documentation (in Arabic) to support their intragroup transactions. The DZIT, at its discretion, reserves the right to examine the taxpayer's records and documentations.

While Saudi tax law does not provide for any specific documentation regarding TP, related-party transactions come under closer scrutiny regarding support for expenses and prices charged between related parties. In addition to costs and charges meeting the general deduction requirements as described above, the DZIT requirements may include the following:

- Copy of purchase orders or agreements.
- Copy of invoices.
- Payment document or bank transfer reference.
- Customs' clearing documents.
- Overseas' auditors certificate to support arm's-length pricing of goods purchased from abroad.

In practice, the DZIT often compare the value of the goods as per the invoice/contracts, the auditors' Certificate, the amount declared for customs' duty, the value as reflected in the financial statements, etc. In the case where the cost of 'Imported Goods' reflected in the income statement would not match with the value of goods declared, for customs' duty purposes, and/or the auditors, the DZIT may disallow deduction of the difference and accordingly raise the assessment of the corporate tax liability and penalty for the period of default. It is therefore important to ensure consistency between the value of the goods as disclosed in the contract/invoice, auditor's certificate, customs' clearances, financial statements, etc.

Transfer pricing controversy and dispute resolution

There are no current TP regulations and guidelines and accordingly, there is no specific rule regarding the burden of proof. However, taxpayers are expected to produce sufficient documentation to support declared intragroup transactions on the tax return.

Comparison with OECD Guidelines

There are currently no TP guidelines in the KSA. However, we understand that the Saudi authorities would soon be issuing specific TP regulations in the KSA. These regulations would most likely follow the OECD Guidelines, but in practice, we note application of the provisions of the UN conventions in certain instances.

Saudi Arabia, Kingdom of

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Singapore

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Overview

Singapore requires compliance of the arm's-length principle for pricing of related-party transactions. The Inland Revenue Authority of Singapore (IRAS) has increased focus on transfer pricing (TP) issues and also significantly stepped up related enforcement activities in recent times.

Country	**Singapore**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No. However, OECD TP Guidelines are used as guidance in applying the arm's-length principle.
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes

Singapore

Country	Singapore
When must TP documentation be prepared?	No statutory deadline for preparation. However, as stipulated under the Singapore TP Guidelines dated 6 January 2015, taxpayers who do not come under specified exclusion situations are required to prepare and maintain contemporaneous documentation prior to or at the time of undertaking the transaction. As a concession, IRAS will treat documentation prepared before tax return filing deadline (currently 30 November of following year) as contemporaneous. Taxpayers are to provide contemporaneous TP documentation within 30 days of the IRAS's request. Taxpayers who come within specified exclusion situations are still required to comply with the arm's-length principle and substantiate compliance with the principle if asked.
Must TP documentation be prepared in the official/ local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes, IRAS may impose penalties under the general penalties regime of the Singapore Income Tax Act (ITA) for violation of record or information-keeping requirements.
Do penalties or fines or both apply to branches of foreign companies?	Yes.
How are penalties calculated?	IRAS may impose penalties under the general penalties regime of the Singapore Income Tax Act (ITA) for violation of record or information-keeping requirements. This can result in a fine not exceeding SGD 1,000 and, in default of payment of fine, imprisonment for a term not exceeding six months.

Introduction

The IRAS has significantly stepped up enforcement of taxpayers' adherence to the arm's-length principle for related-party transactions. Questions regarding transfer pricing of related-party transactions are also now a regular feature of information requests from the IRAS.

Legislation and guidance

Statutory rules

Section 34D of the Singapore Income Tax Act (SITA) empowers the IRAS to make tax adjustments in cases where the dealings between related parties do not reflect arm's-length conditions. On 6 January 2015, the IRAS released the second edition of the Transfer Pricing Guidelines (the Guidelines), an update to the first edition published on 23 February 2006 to provide more comprehensive guidance on the application of TP rules in Singapore.

Anti-avoidance

Section 33 of the SITA contains general anti-avoidance rules that allow IRAS to disregard or revise any arrangement in order to counteract a tax advantage obtained under an existing arrangement. The rules are applicable to any scheme, agreement or transaction as a whole, as well as the component steps by which the arrangement was carried into effect. The anti-avoidance rules do not apply if the arrangement is conducted for bona fide commercial reasons and the reduction or avoidance of tax is not one of its main purposes.

Related party transactions

Section 34D of the SITA empowers the IRAS to make tax adjustments in cases where the dealings between related parties do not reflect arm's-length conditions.

Section 53(2A) of the SITA applies where a resident and a non-resident are closely connected and conduct business in such a way that produces profits to the resident that are less than the ordinary profits that might be expected to arise in such transactions. In such a case, the IRAS may assess and charge the non-resident tax in the name of the resident, as if the resident were an agent of the non-resident. Where the 'true' amount of the profit is not readily ascertainable, the IRAS have the power to assess tax on a 'fair and reasonable' percentage of the turnover of the business done between the resident and the non-resident.

Tax authorities' powers

Under the SITA, the IRAS also has the power to simply refuse to accept a tax return as filed and assess tax based on taxable income determined according to the best of its judgment.

The IRAS introduced Singapore TP Guidelines on 23 February 2006. It released an updated edition of the Guidelines on 6 January 2015. The second edition Guidelines consolidate therein all previous TP related guidance issued by the IRAS since February 2006.

As with the first edition, the second edition Guidelines set out the requirement of Singapore taxpayers to comply with the arm's-length principle for related-party transactions. Unlike the first edition, the second edition Guidelines now set out clearly the IRAS' expectation of Singapore taxpayers to prepare and maintain robust documentation, including contemporaneous TP documentation and the types of information to be found in them, to demonstrate their compliance with the arm's-length principle for related-party transactions, as well as spell out the adverse consequences that Singapore taxpayers could face if they are found to have insufficient documentation in this regard.

The Guidelines continue to provide the procedures for applying for the mutual agreement procedure (MAP) and advance pricing arrangement (APA) facilities, which are used to avoid or eliminate double taxation.

Scope

The guidance on the application of the arm's-length principle covers all related party-transactions of goods, services and intangible properties. The guidance on MAPs and APAs are applicable only to related-party transactions involving at least one party resident in Singapore or a jurisdiction with which Singapore has a comprehensive Double Taxation Avoidance Agreement (DTAA). Further, the Guidelines are applicable where at least one related party is subject to tax in Singapore.

Definition of related party

A related party for Singapore TP purposes is defined in section 34D of the SITA and set out in the Guidelines, as follows:

"A related party, in relation to a person, means any other person who directly or indirectly controls that entity or is controlled, directly or indirectly, by that person, or where both persons, directly or indirectly, are under the common control of a common person."

The Guidelines seek to provide guidance and recommendations on the application of the arm's-length principle with the following three-step approach:

Step 1 – Conduct a comparability analysis

A comparability analysis is conducted to analyse whether the uncontrolled price/ margins being compared to the controlled price/margins have all economically relevant characteristics similar, such that one of the following conditions exists:

- None of the differences of the situations being compared can materially affect the prices or margins being compared.
- Reasonably accurate adjustments can be made to eliminate the effect of any such differences.

The Guidelines also suggest that a comparability analysis should examine the Comparability of the transactions in the following three aspects:

- Characteristics of goods, services and intangible properties.
- Analysis of functions, assets and risks.
- Commercial and economic circumstances.

The Guidelines also include other relevant aspects of a comparability analysis and the IRAS' position on them, such as:

- Evaluating transactions on a separate or aggregate basis.
- Using multiple year data.
- Considering losses.
- Selecting comparables.

The ultimate aim of the comparability analysis is a comprehensive assessment and identification of the areas and extent of significant similarities and differences (such as product characteristics or functions performed) between the transactions/entities in question and those to be benchmarked against.

Step 2 – Identify the appropriate TP method and tested party
The Guidelines indicate that, in theory, the traditional transaction methods provide for a more direct comparison with independent party transactions and hence would be superior to the transactional profit methods. However, the Guidelines recognise that, in practice, the reliability of the results produced by any method would be crucially affected by the availability and quality of data, as well as the accuracy with which adjustments can be made to achieve comparability. Hence, the Guidelines do not have a specific preference for any one method. The Guidelines recommend the adoption of the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments.

The Guidelines allow the Singapore taxpayer to select any one of the following methods for its TP purposes:

- Comparable uncontrolled price (CUP) method.
- Resale price method.
- Cost plus method.
- Profit split method.
- Transactional net margin method (TNMM).

The Guidelines also allow the taxpayer to use a combination of methods and/or modified version of one of these methods to comply with the arm's-length principle, as long as the taxpayer maintains and is prepared to provide sufficient documentation to demonstrate that its transfer prices are established in accordance with the arm's-length principle.

Application of TNMM
The Guidelines suggest certain factors to consider when choosing the net profit indicator/profit level indicator:

- Strengths and weaknesses of the various possible indicators.
- Nature of the transaction and the appropriateness of the indicator applied to the transaction.
- Availability of reliable information needed to apply the TNMM and compute the indicator.
- Degree of comparability between the related and independent party transactions, and the accuracy with which comparability adjustments can be made to eliminate differences.

The Berry Ratio is sometimes used as an alternative financial indicator. The Guidelines explicitly set out the necessary conditions that should be fulfilled/present in a transaction before the Berry Ratio can be applied as a profit level indicator and that it should only be used in limited cases.

Step 3 – Determine the arm's-length results
Once the appropriate TP method has been identified, the method is applied on the data of independent party transactions to arrive at the arm's-length result.

Adjustments relating to TP
The Guidelines provide examples and explanation on four types of adjustments relating to TP, namely:

- Year-end adjustments
- Compensating adjustments
- Corresponding adjustments
- Self-initiated retrospective adjustments

The Guidelines stipulate the IRAS' position on the treatment of upward adjustments and downward adjustments made by taxpayers for each of the four types of adjustments relating to TP. As a general position, the IRAS will bring to tax all upward adjustments but will allow downward adjustments only if certain conditions are fulfilled.

Funding
The IRAS provides guidance on application of the arm's-length principle to related-party loans. Domestic and cross-border loans are covered under the Guidelines.

The taxpayer should adopt the arm's-length methodology in related party cross-border loans. Guidance on comparability adjustments is provided in the Guidelines. From 1 January 2011 onwards, the IRAS requires all related-party cross-border loan arrangements to reflect arm's-length conditions.

Management services
To determine whether related-party services have been provided, the taxpayer can apply the 'benefits test' to the facts and circumstances. The IRAS provides guidance on the list of factors that the 'benefits test' needs to consider.

Taxpayers can adopt the three-step approach to determine an appropriate charge for the service provided based on the arm's-length principle.

1. Perform Comparability Analysis.

When performing a comparability analysis, taxpayers should analyse from the perspective of the service provider and the recipient.

2. Determine the most appropriate transfer pricing method and consider the following if a cost based method or profit level indicator is chosen:
   - CUP method.
   - Cost plus method.
   - TNMM.

3. To determine the relevant cost base, taxpayers need to consider whether a direct or indirect charge method is appropriate and whether the costs are strict pass-through costs.

The Guidelines provide for conditions to be satisfied in order to pass on costs of acquired services to related parties without a mark-up and administrative concessions relating to cost pooling and routine services, with conditions to be met.

Routine Services

The Guidelines state that a 5% mark-up is accepted for only prescribed routine services, provided that they are not also rendered to unrelated parties and that all costs relating to the services performed are taken into account in computing the 5% mark-up. The IRAS would expect a higher profit in the case of greater value-added services provided by a Singaporean entity.

Where a non-resident related party provides management services to a Singaporean entity, the fee charged to the Singaporean entity is generally deductible if the services provided can be identified and the fee is reasonable and appropriate, based on the costs actually incurred by the service provider. Further, there must be a direct benefit to the Singaporean entity to receive a deduction. No Singaporean withholding tax is levied on the payments made by Singaporean entities where services are rendered outside Singapore.

Limitation of double taxation and competent authority proceedings

Singapore has an extensive network of comprehensive double tax agreements (DTAs) modelled largely based on the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention.

All of Singapore's DTAs contain an associated enterprises (AE) article, which provides that the tax authorities of the respective jurisdictions may make adjustments to the profits of an entity in situations where transactions between related enterprises are not conducted based on arm's-length prices. However, a few of its DTAs do not contain the provisions in the AE article, which clarify the obligation of a tax authority to make a correlative adjustment to the profits of its taxpayer where the pricing adjustment made by the other tax authority is appropriate. This could pose issues in practice to taxpayers' access to APA or MAP facilities to help avoid or eliminate double taxation from the perspective of its treaty partners.

Business profits

Singapore's comprehensive double tax avoidance agreements contain a 'Business Profits' article that provides, in general, that business profits of an enterprise are not taxable in Singapore unless that enterprise has a permanent establishment (PE) in Singapore. Where an enterprise has a PE in Singapore, only those profits attributable to that PE may be taxed in Singapore.

The Guidelines state that no further attribution of profits to a PE is required when the following conditions are met:

Taxpayer receives an arm's-length remuneration from its foreign related party that is commensurate with the functions performed, assets used and risk assumed by the taxpayer.

The remuneration paid by the foreign related party to the taxpayer is supported by adequate TP documentation to demonstrate compliance with the arm's-length principle.

The foreign related party does not perform any functions, use any assets or assume any risks in Singapore, other than those arising from activities carried out by the taxpayer.

Penalties

The legislation and the TP Guidelines do not provide penalties specifically directed at TP ‘offences’. However, the general provisions relating to offences and penalties are applicable where the IRAS has a dispute with a taxpayer in relation to its inter-company transactions.

A taxpayer that omits or understates any income may be subject to a penalty equal to the amount of tax that has been or would have been undercharged. Where a taxpayer is found to be negligent in omitting or understating income, the penalty is double the amount of tax that has been undercharged plus a fine not to exceed 5,000 Singapore dollars (SGD), or imprisonment for a term not to exceed three years, or both. A taxpayer who is found to have willfully understated their income with intent to evade tax is subject to more severe penalties.

Further, a taxpayer may be subject to penalty provisions under Section 94(2) of the SITA if the IRAS determines it has violated record- or information-keeping requirements; or a fine not to exceed SGD 1,000; and, in default of payment of the fine, imprisonment for a term not to exceed six months.

Penalties and interest charges on the underpayment of tax are not deductible for tax purposes.

Documentation

The Guidelines stipulate that taxpayers should prepare and keep contemporaneous TP documentation to demonstrate compliance with the arm’s-length principle as part of record keeping requirements for tax and provide guidance on the type of documentation to be maintained.

The Guidelines defined contemporaneous as:

“…documentation and information that taxpayers have relied upon to determine the transfer price prior to or at the time of undertaking the transactions.”

For ease of compliance, the IRAS will also accept as contemporaneous TP documentation any documentation prepared at any time no later than time of completing and filing of tax return for the financial year in which the transaction takes place.

Timing of submission and update

The IRAS does not require documentation to be submitted when the tax returns are filed. Taxpayers should keep the documentation and submit it to the IRAS only when requested to do so. Transfer pricing documentation should be provided within 30 days upon request or otherwise kept for at least 5 years from the relevant year of assessment.

Taxpayers are required to update their TP documentation when there are material changes to the operating conditions that impact their TP analysis. In any case, the IRAS encourages taxpayers to update their contemporaneous TP documentation at least once every three years.

Type of information required
The IRAS has introduced a new two-tiered approach during documentation and specified that TP documentation of taxpayers are to be organised at Group level and Entity level.

At the Group level, the TP documentation should provide a good overview of the group's businesses that is relevant to the business operations in Singapore. This includes:

- General information on the group.
- Description of Group's business relevant to the Singapore taxpayer for the financial year such as important drivers of business profit, list of intangibles and intangible owners, and the financial statements of the group relating to the lines of business involving the Singapore taxpayer.
- Group's financial position for the financial year.

At the Entity level, the TP documentation should provide sufficient details of the Singapore taxpayer's business and the transactions with its related parties. This includes:

- General information on the Singapore taxpayer as at the end of the financial year.
- Description of the Singapore taxpayer's business for the financial year.
- Transactions between the Singapore taxpayer and related parties subject to TP documentation for the financial year.
- Transfer pricing analysis including benchmarking study.

Exclusions
The Guidelines also specify the following five scenarios where the IRAS does not expect contemporaneous TP documentation to be prepared by taxpayers:

1. Domestic transactions (excluding loans between domestic related parties) that are subjected to the same Singapore tax rates for both parties.
2. Loans between domestic related parties (referred to as 'related domestic loans') where the lender is not in the business of borrowing and lending.
3. Companies using the safe harbour provisions of 5% cost mark-up for routine services.
4. Transactions covered by an APA .
5. Quantum of transactions is below specified threshold.

Thresholds for related party transactions above which the IRAS will expect taxpayers to maintain contemporaneous TP documentation
The Guidelines introduced threshold values for related-party transactions below which the IRAS does not expect taxpayers to prepare and maintain contemporaneous TP documentation. It follows that the IRAS expects that taxpayers prepare and maintain such documentation if the value of related-party transactions were to exceed their respective specified thresholds.

These thresholds are as follows:

Category of Related Party Transactions	Threshold (S$) per Financial Year
Purchase of goods from all related parties	15m
Sale of goods to all related parties	15m
Loans owed to all related parties	15m
Loans owed by all related parties	15m
All other categories of related party transactions. Example: Service income Service Payment Royalty income Royalty expense Rental Income Rental Expense For the purpose of determining if the threshold is met, aggregation should be done for each category of related party transactions. For example, all service income received from related parties is to be aggregated.	1m per category of transactions.

Coming within the above exclusion situations however does not exempt the taxpayers concerned from compliance with the arm's-length principle, and they are still expected to be able to support the arm's-length nature of their transactions with other relevant records if asked to do so.

Based on the Guidelines, taxpayers in all cases will be exposed to upward TP adjustment by the IRAS if they are unable to substantiate that TP for related-party transactions are at arm's length and the IRAS has reasons to consider that profits have been understated through improper TP.

In addition, the Guidelines also warn taxpayers that they may suffer the following adverse consequences if they do not have contemporaneous TP documentation:

- Taxation of upward TP adjustments but denial of tax deduction of downward TP adjustments, including year-end adjustments made.
- No support from the IRAS in MAP discussion to resolve double taxation.
- The IRAS may not accept application for an APA.

Availability of comparable information
The IRAS requires TP to be comparable to industry standards. Comparable information is available through databases and public sources.

Transfer pricing controversy and dispute resolution

Guidelines in connection with mutual agreement procedure (MAP)

The MAP aims to provide an amicable way by which competent authorities may eliminate double taxation. Although IRAS would endeavor to eliminate or reduce the double taxation that the taxpayer may encounter, it is possible only if there is concurrence by all competent authorities involved in the process and full cooperation by the taxpayer.

Taxpayers should evaluate their own situations and apply for MAP only if:

- Double taxation has occurred or is almost certain.
- They have complied with the time limit specified in the applicable DTAA for presenting the MAP request.
- They have robust basis and TP documentation in place.
- They have necessary resources to support the process.
- They have evaluated the suitability of MAP by conducting in-depth cost-benefit analysis.

The Guidelines provide guidance on MAP process, benefits, expectations and compliance rules. The procedure involves:

Step 1 – Submit notification of intention to make MAP request
The notification to the IRAS should be made in writing and should describe briefly the circumstances and provide basic information concerning the cause of double taxation.

Step 2 – Hold pre-filing meetings
IRAS would meet the taxpayer within one month of receiving the MAP notification. In the pre-filing meetings, the IRAS evaluates the taxpayer's situation and grounds for making the request as well as the quality and adequacy of the taxpayer's documentation.

Step 3 – Formal application
Unless the IRAS or other relevant competent authorities object to the taxpayer's MAP request, the taxpayer should formally submit a MAP request to the IRAS.

Step 4 – Review and negotiation
IRAS commences the process of MAP and tries to resolve the double taxation issue with the other relevant competent authorities.

Step 5 – Hold post-agreement meeting and implement agreement
Upon reaching agreement with the other relevant competent authorities, the IRAS meets with the taxpayer within one month of reaching the agreement to discuss the details of the agreement and to implement the agreement.

Guidelines in connection with APA

An APA determines, in advance, an appropriate set of criteria to ascertain the transfer prices of specified related party transactions over a specified period of time. The treaty provisions and the domestic tax provisions enable Singapore competent authorities to accede to requests from taxpayers for APAs and enter into such agreements. Singapore allows for unilateral, bilateral as well as multilateral APAs.

The Guidelines provide guidance on the APA process, benefits, expectations and compliance rules for taxpayers seeking to enter into unilateral, bilateral or multilateral APAs. Broadly, the process involves:

Step 1 – Hold pre-filing meetings
Generally, at pre-filing meetings, the taxpayer is expected to explain its APA request, update the IRAS on its meeting with the other relevant foreign competent authorities and present the salient information such as the company's business model and industry information, transactions to be covered, the period of APA, etc.

The first pre-filing meeting with the IRAS should take place at least nine months from the first day of the APA covered period. The IRAS discourages anonymous requests to discuss potential APAs. If the IRAS is willing to accept the APA, it advises the taxpayer on the appropriate follow-up action.

For an effective discussion, the taxpayer needs to provide the minimum information required for the pre-filing meeting at least one month before the meeting.

Step 2 – Submit formal APA
Unless the IRAS or the other relevant foreign competent authorities disagree, the taxpayer should formally submit an APA request at least six months before the first day of the proposed APA covered period.

Step 3 – Review and negotiate APA
Within one month of receipt of the formal application, the IRAS informs the taxpayer of whether the APA application has been accepted or rejected. The taxpayer should note that the IRAS reserves the right to propose alternative methodologies or to request a restriction or expansion of the scope of the proposed APA subsequent to the formal submission of the APA application. If the IRAS accepts the APA application, it begins the process of engaging the relevant foreign competent authorities with the view of reaching agreement on an APA (in case it is a bilateral or multilateral APA).

Step 4 – Hold post-agreement meeting and implement APA
Upon reaching agreement, the IRAS meets with the taxpayer within one month of reaching the agreement to discuss the details of the agreement and to implement the agreement.

Other regulations
The IRAS may release other guidance in the form of interpretation and practice notes or administrative statements on a variety of issues. These publications do not have the force of law and are not binding on taxpayers. However, they do provide the IRAS' position on the law and its administrative practices in its application of the law.

Legal cases
To date, no specific cases relating to transfer pricing issues have been brought before a Singapore court. However, case law from other common law jurisdictions may be applicable on a case-by-case basis.

Burden of proof
It is common for the IRAS to query the basis of inter-company charges or transactions by requesting that a taxpayer provide evidence that such transactions are at arm's length. The burden of proof lies with the taxpayer.

Tax audit procedures
The IRAS has in place a Transfer Pricing Consultation (TPC) programme since 2008. The Guidelines provide for the objectives and the TPC process.

The objective of the TPC is to ensure taxpayers comply with the Guidelines and identify areas in which the IRAS can advise taxpayers on good practices in transfer pricing. The IRAS selects taxpayers for TPC based on risk-based indicators. Where necessary, the IRAS may send questionnaires or information requests to obtain more data or information from taxpayers for risk assessment purposes.

The consultation process with a selected taxpayer starts with IRAS arranging for a first meeting at the taxpayer's premises where the IRAS will interview the key personnel and review the TP documentation. After first meeting, IRAS will request for more information or documents and may arrange subsequent meetings with the taxpayer. Based on information submitted, IRAS will assess adequacy of the TP documentation and identify issues for further discussion with the taxpayer.

The IRAS may propose a tax adjustment under Section 34D if the taxable profit is understated due to non-arm's-length transactions and the taxpayer is allowed to respond and discuss how to resolve before IRAS makes the tax adjustment. At the conclusion of the TPC, IRAS will send a closing letter.

Revised assessments and the appeals procedure
If the IRAS does not agree with a taxpayer's tax return, it may, within six years after the year of assessment (for year of assessment 2007 and earlier) and four years after the year of assessment (for year of assessment 2008 and thereafter), issue a notice of assessment based on its 'best judgment'. A taxpayer that disagrees with a notice of assessment must object in writing within 2 months from the date of the notice. As the taxpayer is required to provide detailed grounds for objection, documentation to support its inter-company pricing should be available at this time. The IRAS considers the grounds for the objection, including any documentation received, and will issue a response in writing within six months from the date of receipt of the last correspondence with complete information. Taxpayers would need to state in writing if they agree with the IRAS decision as per the date stated in the letter, or within 3 months from the date of letter. If the IRAS and the taxpayer are unable to reach an agreement, a 'Notice of Refusal to Amend' is issued.

Taxpayers have the right to appeal to the Board of Review if they are dissatisfied with the IRAS' decision. Based on the decision of the Board of Review, the taxpayer or the IRAS may choose to appeal to the High Court. Subsequently, application may be made to the Court of Appeal if either party is dissatisfied with the High Court's decision. However, the Court of Appeal does not hear appeals on a question of fact.

Resources available to the tax authorities
The IRAS is known to organise relevant training within to strengthen the capability and capacity of its tax assessors and auditors to enforce transfer pricing matters. It is also known that the IRAS officers receive regular training organised with trainers from OECD. The IRAS is also engaged in regular sharing of knowledge and best practices including in the transfer pricing area with other tax authorities.

Comparison with OECD Guidelines

The arm's-length principle
The arm's-length principle described in the Guidelines and legislated in the SITA is in line with the arm's-length principle set out in the OECD Model Tax Convention on Income and Capital and the OECD Transfer Pricing Guidelines (i.e. the arm's-length principle requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent entity).

The Guidelines, however, recognise that establishing and demonstrating compliance with the arm's-length principle requires exercise of judgment and recommend that taxpayers adopt a pragmatic approach to ascertaining arm's-length pricing for related-party transactions.

Singapore

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Slovak Republic

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Overview

The Slovak transfer pricing (TP) rules generally follow the Organisation for Economic Co-operation and Development (OECD) rules. Prices between related parties must be set at fair market value (the arm's-length principle) for tax purposes. A taxpayer may apply to the tax office for approval of the TP method, and from 1 September 2014 they have to pay consideration ranging from 4,000–30,000 euros (EUR) together with the application. A related party (an individual or an entity) is a relative, a party economically or personally related, or a party otherwise connected (this relationship arises if the parties have established a business connection solely for the purpose of decreasing the tax base). As of 1 January 2015, also transactions between Slovak related parties are subject to TP rules.

The tax authorities can increase the tax base and assess penalties if they decide that arm's-length prices were not used in transactions between related parties, and this has resulted in a reduction in tax base, or increase of the tax loss, of either of the entities. For TP purposes, taxpayers have to keep TP documentation to a specifically prescribed extent and present it within 15 days to the tax authorities upon request, even without opening an official tax inspection (before 31 December 2013, the period was 60 days, and during official tax inspection only). The number of tax inspections focused on TP is increasing.

Country	**Slovakia**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes (penalty for not providing the TP documentation only)

Slovak Republic

Country	Slovakia
When must TP documentation be prepared?	Presented upon request (15 days)
Must TP documentation be prepared in the official/local language?	Yes (only exceptional foreign languages are accepted, at the discretion of tax office)
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Flat penalties of three times the European Central Bank's interest rate (not less than 10%) times the difference in tax charge. Penalties of 10% p.a. (up to the amount of additional tax assessment) are proposed from 2016 onwards.

Introduction

The Slovak tax system was established in 1993. Tax legislation attempted, in basic terms, to prevent deviations from arm's-length prices in related-party transactions. One of the major milestones in Slovak TP history was December 2000, when Slovakia joined the OECD. As a result, taxpayers could adopt the OECD Guidelines with some degree of certainty that the treatment would be acceptable to the Slovak tax authorities. Furthermore, the Slovak Ministry of Finance has issued an official translation of the TP Guidelines for Multinational Enterprises and Tax Administrations, published by the OECD. Slovak tax authorities' practical experience with TP principles are that of an underdeveloped country's level, although they have increased significantly in the last few years.

Legislation and guidance

Corporate income tax

The Slovak Income Tax Act and Slovak TP regulations cover transactions with foreign related parties (as of 1 January 2015 also transactions between Slovak related parties). Generally, the prices in transactions between foreign related parties are required to be at arm's length. Related parties are defined as a Slovak tax resident and/or a non-Slovak tax resident, which are one of the following:

- Relatives.
- Entities that are economically or personally related.
- Entities with certain other relationships.

Economically or personally related means one of the following:

- When one entity directly or indirectly holds more than 25% of the share capital or voting rights of the other.
- An entity and its statutory representative or a member of its supervisory board.
- Two or more entities in which a third entity directly or indirectly holds more than 25% of the share capital or voting rights.
- Entities having the same person as their statutory representative or a member of their supervisory board.

However, according to the full extensive definition set in the Slovak Income Tax Act, all companies within the company group are likely to qualify as related parties. Entities with certain other relationships are parties connected solely for the purpose of reducing the tax base. Furthermore, a Slovak permanent establishment (PE) and its foreign headquarters, as well as foreign PEs and their Slovak headquarters, are also considered foreign related parties for TP purposes.

The Slovak tax authorities can, in advance, approve a particular method of setting the price in transactions with foreign-related parties. They are obliged to issue a decision on a particular method to be used, if requested by a taxpayer. They only occasionally confirm prices used, but do not publish any benchmarks.

The approved method can be used for up to five tax periods, and can be extended for another five tax periods if certain conditions are met. The tax authorities can cancel or amend their decision if the method was approved, based on false or inaccurate information provided by the taxpayer, or if the relevant conditions had changed. The tax authorities may also cancel or amend their decision, based on the request of the taxpayer proving that conditions have changed. A consideration ranging from EUR 4,000–30,000 (depending on complexity of the transaction) is imposed for advance method approval from September 2014.

In addition, the tax authorities can approve a method for determining the corporate income tax base of a Slovak PE of a foreign taxpayer per the taxpayer's request. This method is usually based on one of the OECD TP methods.

For certain related-party transactions the Slovak tax authorities generally accept as the arm's-length price value, as appraised by an independent valuation expert.

From 2009, all Slovak taxpayers have to report a value of intragroup transactions performed in each particular tax year in their corporate income tax return forms.

Thin capitalisation rules

From 2015 onwards, interest costs on loans provided by related parties are tax deductible at no more than 25% of EBITDA (the total of the result of operations before tax, including depreciation charges, and the interest expense). Interest on loans from/to related parties should still be set at arm's length for tax purposes.

Value-added tax
If the actual price that a Slovak VAT payer charges for supplies of goods and services to any person or entity which is a related party, as defined in Slovak VAT law, is lower than the market value, then the tax base shall be the market value if the recipient is either:

- not registered for Slovak VAT, and
- a Slovak VAT payer (registered for Slovak VAT as a domestic or foreign entity), but does not have the right to claim the full input VAT from these goods and services.

A related party to the VAT payer is, for example, a statutory body or statutory representative of the VAT payer, an entity who directly or indirectly owns or controls 10% or more of shares of the VAT payer supplying the goods or services, or one that is directly owned or controlled by 10% or more of shares of this VAT payer or employees of the VAT payer.

Other taxes
With respect to real estate tax, the value of the real estate, based on which the tax base is determined, should generally be set according to the appendix to the Real Estate Tax Act. In specific cases, it should be based on the arm's-length price, determined by an independent, court-approved valuation expert, who must value the real estate under specific regulations.

Customs
Since its accession to the EU on 1 May 2004, Slovakia has followed the EU Customs Code, based on the transaction value. For sales between related parties, the price applied in any particular case should approximate the transaction value in sales of identical or similar goods between buyers and sellers who are not related.

Penalties
In case the taxpayer fails to provide the TP documentation to the Tax Authority within 15 days from their request, a penalty of up to EUR 3,300 can be imposed.

According to the Slovak Act on Tax Administration, the tax administrator should impose a fixed penalty equal to three times the European Central Bank's interest rate on the difference in tax between that shown in the tax return and that determined by the tax administrator (but not less than 10%). New regime of penalties of up to 10% p.a. from the additional tax assessment (up to the amount of additional tax assessment) is proposed from 1 January 2016 and will likely apply to all earlier years still open to tax inspection as of 2016.

In the event of late payment of the tax liability declared in the tax return, the tax administrator can impose interest of four times the European Central Bank of Slovakia's interest rate on overdue tax. This applies to each day of late payment, up to a maximum period of four years.

Documentation

Generally, the burden of proof rests with the taxpayer.

At the beginning of 2009, the Slovak Ministry of Finance issued a guideline which set out the content of obligatory TP documentation (the Guideline). Under the Guideline, a Slovak company's obligatory TP documentation should include information that explains how the prices applied in material transactions with foreign related parties have been set, and justifies their arm's-length nature. The Guideline was updated in 2014, and then another update is expected again in April 2015 to reflect the introduction of documentation requirements for domestic related-party transactions.

The TP documentation is required for all tax periods during which the Slovak taxpayer carries out material transactions with its foreign-related parties. It must be in Slovak, unless the tax authorities agree to accept documentation in a different language.

Moreover, the Guideline introduces three types of TP documentation:

- Full TP documentation.
- Basic TP documentation.
- Simplified TP documentation.

The full TP documentation is required only for material transactions undertaken by entities that prepare their financial statements under the International Financial Reporting Standards (IFRS) for Slovak statutory purposes. Simplified TP documentation is required for small entities (so called 'micro accounting units'). Other entities should maintain basic TP documentation in order to justify prices applied in their material foreign related-party transactions. Based on the available draft 2015 update of the Guideline, transactions between Slovak related parties should generally be subject to simplified TP documentation requirements, unless they conduct transactions with parties from non-treaty countries, utilise significant amount of tax losses, or benefit from tax types of incentives/state aid.

The full TP documentation under the Guideline is based in the EU recommendations, and should include general TP documentation (a master file) and specific TP documentation (a local file).

The master file includes the following information about the pricing policy within the entire group or related entities (Slovak and foreign):

- The identification of group members.
- The group ownership structure.
- A business description.
- Industry identification.
- The business strategy of the group.
- A description of the functions undertaken and the risks assumed by individual entities within the group.

The local TP documentation should contain the following specific information about the Slovak entity and its transactions with its foreign-related parties:

- The identification of the entity and its ownership.
- A description of the company's business and industry.
- The company's organisational structure and a list of foreign-related parties.
- The company's planned business strategy and business plan.
- A list and description of transactions or services provided to foreign-related parties.
- An overview of the company's intangible assets.
- A description of the functions undertaken and the risks assumed by the Slovak company.
- Information on the choice and application of TP methods.
- Information on comparable data (benchmarking study).

Taxpayers are obliged to provide the TP documentation within 15 days of the tax authority's request (without formal opening of a tax inspection). Therefore, it is recommended to prepare the documentation at the same time the foreign-related-party transactions are carried out.

Transfer pricing controversy and dispute resolution

The TP inspection and potential additional tax charges on the grounds of TP could be assessed for 11 years following the year or tax period concerned. As a result, the standard six- or eight-year statute of limitation period does not apply in case of TP.

As the tax authorities become more familiar with TP principles and begin to understand the background to transactions between related parties, the importance of having sufficient and technically sound documentation increases. The tax authorities started to make special TP tax inspections and have formed a specialised group of TP experts. They have recently hired a couple of high-profile professionals.

The tax office continues to train a specialised group of staff to handle TP audits and has already performed a number of TP tax inspections of multinational companies, resulting in significant additional tax charges. As communicated by tax authorities, the number of tax inspections focused on the TP area significantly increased in 2014 in comparison to previous tax periods.

Comparison with OECD Guidelines

The Slovak TP rules generally follow the OECD rules. In 2001, the TP legislation introduced a number of methods to determine the arm's-length price for cross-border transactions between related parties. These methods broadly equate to the transaction-based methods and profit-based methods according to the OECD Guidelines. The transaction-based methods listed include: comparable uncontrolled price, resale price and cost plus methods. The profit-based methods listed include: the transactional net margin and profit split methods.

The Slovak taxpayer can also use a combination of these methods, or choose any other method, provided the method used is in accordance with the arm's-length principle. As of 2014, the Slovak tax legislation has adopted the latest OECD Guideline version, which removed the hierarchy of TP methods.

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Slovenia

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Overview

Transfer pricing (TP) is one of the main areas of tax investigation of the Slovenian tax authorities. Under these circumstances, multinational companies are advised to pay close attention to the arm's length of their inter-company transactions and their documentation, so as to be prepared in case of any TP disputes with the tax authorities.

In recent cases, the Slovenian tax authorities adjusted the taxable result of taxpayers in accordance with the applicable regulations. The adjustments are carried out so that the profitability of the taxpayer falls within the interquartile range of the arm's-length interval derived through a benchmarking study. Most challenges and disputes generally arise in relation to the economic analysis (i.e. TP method used).

Taxpayers should address with careful consideration the documentation of their inter-company transactions. Having appropriate TP documentation in place is, in all circumstances, a safeguard against non-compliance penalties and adverse tax consequences, which can result from TP adjustments. The TP file should be presented, upon request of the tax authorities, during a tax audit.

Country	**Slovenia**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Continuously, no later than three months after business year-end

S

Slovenia

Country	Slovenia
Must TP documentation be prepared in the official/local language?	No, however upon the request from Tax Authorities needs to be translated
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Prescribed amount and as a percentage of the adjustment to taxable income if above certain threshold

Introduction

The Slovenian TP legislation follows the Organisation for Economic Co-Operation and Development (OECD) Guidelines and requires that transactions between related parties be carried out at market value. In case transfer prices are not set at arm's length, the Slovenian tax authorities have the right to adjust taxpayers' revenue and expenses so as to reflect the market value. Profit adjustments on transactions between related parties can be performed within the domestic statute of limitation period (i.e. five years).

Slovenian taxpayers engaged in related-party transactions do not have the possibility to apply for advance pricing agreements.

Legislation and guidance

The arm's-length principle

The arm's-length principle is described in Article 16 of the Slovenian Corporate Income Tax Act (CITA), which is valid from 1 January 2007. In establishing a taxable person's revenues and expenses, the pricing of transfers of assets (including intangible assets) between related parties and inter-company services should not be less than the arm's-length principle.

Definition of related parties

Provisions in Articles 16 and 17 of the CITA differentiate between the definition of related parties, depending on whether the transactions are cross-border or domestic.

Cross-border controlled transactions are transactions between a taxable person (resident) and a foreign entity (non-resident), related in such a way that:

- the taxable entity, directly or indirectly, holds 25% or more of the value or number of shares of a foreign entity through holdings, control over management, supervision or voting rights, or controls the foreign entity on the basis of a contract or terms of transactions different from those that are, or would be, achieved in the same or comparable circumstances between unrelated parties

- the foreign entity, directly or indirectly, holds 25% or more of the value or number of shares of a taxable entity through holdings, control over management, supervision or voting rights, or controls the taxable entity on the basis of a contract or terms of transactions different from those that are, or would be, achieved in the same or comparable circumstances between unrelated parties
- the same entity, directly or indirectly, holds 25% or more of the value or number of shares, or participates in the management or supervision of the taxable entity and the foreign entity, or of two Slovenian taxable entities, or they are under the same control on the basis of a contract or transaction terms that differ from those that are, or would be, agreed in the same or comparable circumstances between unrelated parties, and
- the same individuals or members of their families, directly or indirectly, hold 25% or more of the value or number of shares, holdings, voting rights or control over the management or supervision of the taxable entity and the foreign entity, or of two Slovenian tax resident entities, or they are under their control on the basis of a contract or transaction terms that differ from those that are, or would be, agreed in the same or comparable circumstances between unrelated parties.

Domestic inter-company transactions are transactions between two taxable resident persons. Residents shall be related parties if either of the following conditions exist:

- They are related in terms of capital, management or supervision by virtue of one resident, directly or indirectly, holding 25% or more of the value or number of shares, equity holdings, control, supervision or voting rights of the other resident, or controls the other resident on the basis of a contract in a manner that is different from relationships between non-related parties.
- The same legal or natural persons or their family members, directly or indirectly, hold 25% or more of the value or number of shares, holdings, control, supervision or voting rights, or control the residents on the basis of a contract, in a manner that is different from relationships between non-related parties.

Related parties are also taxable and natural persons performing business, provided that such natural persons (or their family members) hold 25% or more of the value or number of shares or equity holdings, or participate in the management, supervision or voting rights of the taxable person, or control the resident on the basis of a contract in a manner that is different from relationships between non-related parties.

Notwithstanding the above provisions, the tax base may be adjusted only in cases when one of the residents: (i) has an unsettled tax loss from previous tax periods in the tax period concerned, or (ii) pays tax at a rate that is lower than the standard corporate tax rate of 17%, or (iii) is exempt from paying corporate tax.

Transfer pricing methods
Comparable market prices are determined by one of the five methods or a combination of these methods as specified in OECD Guidelines:

- comparable uncontrolled price (CUP) method
- resale price method (RPM)
- cost-plus method (CPM)
- transactional net margin method (TNMM)
- profit split method (PSM).

All the above-mentioned methods are equivalent, which means the company may choose either the traditional transactional methods or transactional profit methods. However, the use of the CUP method has priority over transactional methods. The most important change is the usage of an interquartile range, when determining the arm's-length price, in comparison to the previous legislation, where the use of the median was obligatory.

The Slovenia Ministry of Finance issued regulations on TP which came into force on 1 January 2007. These regulations set out in more detail the application of the five pricing methods in a manner similar to that outlined in the OECD Guidelines.

Comparable information

Comparable information is required to support the arm's-length nature of related-party transactions and should be included in the taxpayer's TP documentation. The arm's-length nature of transactions with related parties can be demonstrated by applying one or more of the prescribed acceptable methods. Acceptable methods include the traditional OECD methods or any combination of them. The CUP method is the preferred method as defined in the regulations on TP. Additionally, the CUP method, the RPM and the CPM are preferable methods compared to the PSM and the TNMM. In practice, it is often not easy to obtain information on CUPs.

The Slovenian tax authorities have access to the Amadeus database and local databases containing financial information for Slovenian companies, such as GVIN and IBon. In accordance with the Slovenian Companies Act, companies and sole proprietors are required to submit annual reports that are publicly available.

The Slovenian tax authorities have a preference towards using local comparable companies for benchmarking purposes, although a pan-European benchmark may also be accepted.

Other regulations

The Slovenian Ministry of Finance has issued explanatory regulations on TP and regulations on reference interest rates.

The regulations on reference interest rates define a methodology for determining a reference interest rate on inter-company loans between related parties, to be taken into consideration when determining revenues and expenses. The reference interest rate is the sum of a variable part of an interest rate (e.g. EURIBOR, LIBOR-USD) and a mark-up expressed in basis points, which is determined for a particular maturity period and depends on the credit rating of the taxable person (i.e. borrower).

Regulations on TP replaced the regulations on determination of comparable market prices and introduced some important changes. The most important changes are provisions on the use of cost contribution agreements and the use of the interquartile range when determining an arm's-length price. Moreover, the use of multiple-year data is accepted. In addition, the regulations set out situations where business interdependence can arise without one party having at least a 25% share in the other party.

The regulations also pay attention to the loss positions of related entities resulting from inter-company transactions. This approach tests whether comparable unrelated-party transactions would be profit-making by considering whether an independent entity would be in a loss position under the same circumstances.

Penalties

Any entity engaged in intragroup transactions must be able to support the prices agreed between related parties in meeting the arm's-length criteria. Failure to comply with these laws may result in significant tax exposure and penalties.

Sanctions include adjustment of the tax base to increase the tax charge (or reduce a tax loss), as well as the following penalties in accordance with the Tax Procedure Act (TPA):

- Penalty from 1,200 to 15,000 euros (EUR) for the legal entity and EUR 600 to EUR 4,000 for the responsible representative of the legal entity.
- For medium or large companies the penalty from EUR 3,200 to EUR 30,000 for the legal entity and EUR 800 to EUR 4,000 for the responsible representative of the legal entity.
- If the underpaid tax is higher than EUR 5,000, an additional penalty of 30% of the underpaid tax (between EUR 1,200 and up to EUR 150,000) may be levied.
- For medium or large companies an additional 45% of underpaid tax (underpaid tax from EUR 2,000 to EUR 300,000) may be levied as a penalty.
- Additional fines of up to EUR 5,000 for the responsible person, plus late payment interest.

For taxes not paid within prescribed deadlines, late payment interest is levied at a daily interest rate of 0.0274%.

If adequate TP documentation is not prepared or is not prepared according to the terms defined by the tax authorities and size of the company, the penalty is EUR 1,200 to EUR 15,000 for the legal entity and EUR 600 to EUR 4,000 for the responsible representative of the legal entity.

Documentation

A taxable entity must maintain information about related parties, the types and extent of business transactions with these entities and the determination of comparable market prices as prescribed by the TPA. The provisions of the TPA on TP follow the EU Code of Conduct on TP documentation for associated enterprises in the European Union (EU TPD). Therefore, companies need to prepare a masterfile and country-specific documentation as described below:

- The masterfile should contain at least the description of the taxable entity, group structure and type of relationship, TP system, general business description, business strategy, general economic and other factors, and competitive environment.
- The country-specific documentation should contain information about transactions with related entities (description, type, value, terms and conditions), benchmark analysis, functional analysis, terms of contracts, circumstances that have an influence on transactions, application of the TP method used and other relevant documentation.

The masterfile must be assembled concurrently, and no later than the submission of the tax return. The Ministry of Finance determines what information should be provided upon submission of the tax return.

If the masterfile is not in the Slovenian language, it must be translated on the request of the tax authorities within a minimum of 60 days.

Transfer pricing controversy and dispute resolution

Tax audits

The Slovenian tax authorities began to perform tax inspections concerning the fulfilment of TP documentation requirements in the second half of 2006. Only limited numbers of legal cases in respect to TP were in Slovenia so far, focused mainly on recipient of intercompany services.

To date, the Slovenian tax authorities have started to commence specific transfer-pricing-oriented audits. In the loop of Slovenian tax authorities are multinational companies that are showing tax loss or performing restructuring of the business. Tax authorities are focusing on a specific industry; in the past, these were the pharmaceutical, financial and automotive industries.

Burden of proof

In Slovenia, the burden of proof lies with the taxpayer, who should prepare TP documentation in order to defend the arm's-length nature of its transfer prices. In the case of litigation, however, the burden of proof may shift to the tax authorities in order to demonstrate that the transfer prices set by the taxpayer are not at arm's length.

Comparison with OECD Guidelines

In general, Slovenian TP rules and guidance follow OECD Guidelines. The difference is in justification of arm's-length principle for inter-company loans where special regulation (as described above) should be followed.

88.

South Africa

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Overview

In the 2010 Budget Speech, Finance Minister Pravin Gordhan said, "Steps will be taken against several sophisticated tax avoidance arrangements and the use of transfer pricing and cross-border mismatches." It follows that South Africa (SA) has been very aware of the misuse of transfer pricing (TP) by companies (referred to by Judge Davis of the Davis Tax Committee, see further comments below, as 'transfer mispricing') and the ensuing loss to the fiscus even before the OECD released its original report on Base Erosion and Profit Shifting (BEPS).

South Africa is part of the G20 and so is one of the countries that is driving the BEPS debate and agenda. South Africa recognises its role, in this respect, as representing Africa and through its membership of the Africa Tax Administrators Forum (ATAF) is working with other African Revenue Authorities to combat transfer mispricing and harmonise the Region's approach to this area of taxation.

In the 2013 Budget Speech, the Minister of Finance announced that a tax review committee would be set up to "inquire into the role of SA's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability". The Davis Tax Committee (DTC) was set up on 17 July 2013 and part of the DTC's role was to address concerns about BEPS, especially in the context of corporate income tax, as identified by the OECD and G20. The DTC set up a BEPS sub-committee which released a report in December 2014 that sets out the DTC's position as at 30 September 2014. One of the key recommendations from the DTC report is that the South African Revenue Service (SARS) should expand the capabilities of its TP team and that the TP disclosures in the income tax return should be enhanced so that timely decisions can be made on the tax assessment.

In the February 2015 Budget Speech, the Minister of Finance noted that "many countries face the problem of businesses exploiting gaps in international tax rules to artificially shift profits and avoid paying tax". These avoidance measures, practiced widely by multinational firms, substantially reduce their contributions to national tax bases. In recent years, government has taken measures to limit artificial reductions of taxable income through cross-border interest payments. Building on these steps, government will propose amendments to improve TP documentation and reporting,

and change the rules for controlled foreign companies and the digital economy. These proposals are in line with matters examined in a recent OECD report, *Addressing Base Erosion and Profit Shifting*, which examined the practice. A December 2014 report by the Davis Tax Committee on the same subject highlighted these concerns in the South African context. "Tax returns will place a greater focus on indicators of potential base erosion and profit shifting."

The revision of section 31 of the Income Tax Act 58 of 1962 (the SA ITA) to align SA's legislation with the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention was one of the major steps taken in 2011 and 2012 to address the issue of the misuse of TP. The revised legislation makes arm's-length transactions compulsory for all international dealings between connected persons.

The discretion and duty to adjust arm's-length prices no longer rests with the Commissioner of SARS, but instead, it is the taxpayer's responsibility to determine arm's-length transfer prices. It is the stated intention of the SARS to provide an update to Practice Note 2 (PN2) and Practice Note 7 (PN7), following the amendments to the legislation; however, at the time of this publication these had not been released. The DTC also indicated that these Practice Notes should be updated as soon as possible.

Country	**South Africa**
OECD member?	No (SA has observer status)
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No (the OECD Guidelines are however referred to in Practice Note 7) Practice
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No, but similar provisions apply to resource royalties.
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes in practice, plus specific protection where TP documentation is opined upon positively by a Registered Tax Practitioner, such as PwC SA.
When must TP documentation be prepared?	Upon request by SARS within 21 days. In principle, documentation should be in place by the due date for filing income tax returns (generally 12 months after a company's financial year-end).
Must TP documentation be prepared in the official/local language?	Yes (English is one of the 11 official languages of SA)
Are related-party transactions required to be disclosed on the tax return?	Yes

Country	South Africa
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Percentage of tax payment

Introduction

TP legislation has been in SA law since 1995; however, it has only been in recent years that the SARS has started to focus on this area. The rules require those subject to tax in SA to follow the arm's-length principles in their dealings with cross-border connected persons who are not tax-resident in SA. The TP rules were recently overhauled and the new rules apply to years of assessment, commencing on or after 1 April 2012.

The fundamental principle underpinning the SA TP legislation, since inception, has been the arm's-length principle as set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and Capital as well as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines).

SA is still in its infancy with respect to auditing related-party cross-border transactions, even though TP legislation has been in existence in SA for some time (since July 1995). The SARS has only in the last few years begun to audit TP aggressively, owing mainly to a lack of resources and skills' challenges. Equally, SA companies of multinational groups are also starting to focus on their TP compliance. In the last year, we have seen in increase in SARS audit activity in connection with TP.

Paragraph 16.2 of PN7 provides that due to various factors, the advanced pricing agreement (APA) process will not be made available to SA taxpayers. However, based on our recent discussions with the SARS, we understand that they are serious about introducing an APA programme and that it could well be introduced in SA within the next one to three years, depending on resource criteria and constraints.

SA has a wide treaty network and is actively pursuing new treaties. SA recently introduced withholding tax on interest with effect from 1 March 2015. It is accordingly important to consider whether the lender is tax resident in a treaty country and whether treaty relief is in point and the extent to which local returns and claims are required to obtain the relevant treaty relief.

Historically, exchange controls have policed the flow of funds in and out of SA and have served as a protection against tax base erosion through inappropriate non-arm's-length TP. Technically, such non-arm's-length TP is a criminal offence in terms of SA's exchange control laws and regulations. It follows that having TP documentation in place that supports the arm's-length nature of the TP is accordingly a commercial necessity, required to manage this potential exchange control risk. ATAF, the global developments in connection with BEPS and training initiatives by overseas revenue authorities to African revenue authorities, is currently driving the adoption of TP regulations in Africa. The creation of the ATAF has also seen increased information sharing among African tax administrators. Information sharing will likely increase as

the new OECD rules on TP (for example, the three-tier approach) comes into effect in 2016/2017. During the ATAF consultative conference on new rules of the global tax agenda in March 2014, after noting the various concerns expressed by all countries participating in the consultative process, the five major areas broadly identified were the following:

- The digital economy – a new form of economy that requires new rules and greater understanding of TP and the implementation of new legislation.
- TP – While African countries are at various levels in this area, developing the legislation and skills in TP remains crucial in understanding the behaviour of multinational enterprises (MNEs).
- Taxation of the extractive industry – this industry carries large amounts of potential revenue and it is dogged by unsustainable tax incentives and exemptions.
- Tax instruments and information – the lack of treaties, agreements and accessible databases that enhance the understanding of the operations of MNEs for audit purposes.
- The informal sector – remains a large portion of potential tax.

Legislation and guidance

SA's TP legislation (set out in section 31 of the SA ITA) came into effect on 1 July 1995, followed by PN 2 (introduced 14 May 1996) and PN7 (introduced 6 August 1999), which served to provide taxpayers with guidance on how the SARS intended to apply the legislation. PN2 covered thin capitalisation while Practice Note 7 deals with TP. As of 1 April 2012, the SARS made several amendments to SA's TP rules.

As noted earlier, in terms of the current TP rules, a taxpayer is required to assess the arm's-length nature of its cross-border transactions with connected persons. In essence, the transactions should be carried out on the same basis that they would have been if the parties (to the transactions) were independent third parties trading on a normal commercial arm's-length basis. If the transactions are not taking place on an arm's-length basis (specifically where the charges to the SA counter-party is higher than it would have been under arm's-length conditions), the taxpayer is required to make a self-adjustment to bring the transactions in line with the arm's-length principle. This is different to the TP legislation that existed before where SARS, rather than the taxpayer, was required to make the TP adjustment.

In terms of the updated wording of section 31(2) of the SA ITA, a TP adjustment will arise where a transaction, operation, scheme, agreement or understanding constitutes an affected transaction and where:

- the terms or conditions are different to the terms and conditions that would have existed had those persons been independent persons dealing at arm's length, and
- it will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding.

Generally speaking, a transaction, operation, scheme, agreement or understanding will constitute an 'affected transaction', where it is directly or indirectly entered into for the benefit of either or both, an SA resident taxpayer and an offshore connected party. The reference to direct and indirect is important as it potentially widens the application of the legislation.

The taxable income or tax payable by any person deriving a tax benefit must be calculated as if the transaction, operation, scheme, arrangement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length. To the extent that there is a difference between the actual taxable income and the taxable income calculated on the basis outlined above, there will be a TP adjustment to taxable income, which is subject to corporate income tax at 28% (this is referred to as the primary adjustment).

The TP adjustment takes the form of a primary adjustment (in essence, being the disallowance of the deduction of the amount which is not arm's length) as well as a secondary adjustment. The replacement of Secondary Tax on Companies with Dividends Withholding Tax (DT), with effect from 1 April 2012, necessitated the introduction of a new secondary adjustment for TP purposes. Any TP adjustments prior to 1 January 2015 gave rise to a deemed loan of an amount equal to the TP adjustment. Interest (at an arm's-length interest rate) was levied on the deemed loan amount which was included in income on an annual basis. The deemed interest was capitalised to the outstanding deemed loan balance. The legislation did, however, not cater for a mechanism to 'repay' the deemed loan.

Due to the problems that arose with the deemed loan mechanism, in line with the recommendations by the DTC, with effect from 1 January 2015, the law has been amended and the secondary adjustment will now be in the form of a deemed dividend *in specie*. The dividend is deemed to have been declared and paid to the other party to the transaction at the end of six months after the end of the year of assessment to which the TP adjustment relates. The dividend withholding tax (WHT) would be payable to SARS the month after the deemed dividend was declared (i.e. seven months after year-end). The reason for this is to align the timing of the deemed dividend with the timing of the calculation of the third provisional top-up payment.

The WHT rate on any such deemed dividends may well be 15% as the Double Tax Agreement (DTA) between SA and the country of residence of the foreign counterpart may not necessarily reduce the withholding tax on a deemed dividend.

The new secondary adjustment rules also include transitional arrangements to address deemed loans that arose prior to the new deemed dividend rules coming into effect. In terms of the transitional rules, any deemed loans in existence as at 1 January 2015 is effectively treated as repaid on 1 January 2015 and the amount thereof is treated as a divided *in specie*. Any dividend tax due on the deemed dividend will be payable to the SA Revenue Service by 28 February 2015.

It should be noted that, if SARS makes an adjustment after 1 January 2015, for years of assessment commencing on or after 1 April 2012 but before 31 December 2014, the 'old' deemed loan and deemed interest rules will apply. On 1 January 2015, there will be a deemed dividend and interest will run on any unpaid dividend withholding tax post 28 February 2015.

Sections 31(6) and 31(7) of the SA Income Tax Act also provide some carve-outs from the application of the TP rules in certain circumstances, essentially for transactions within a group of companies, where the other party is in a high taxed jurisdiction, for example, in connection with financial assistance between a resident and a controlled foreign company in relation to the resident. There are also certain exemptions from the TP rules in connection with the use, right of use or permission to use any intellectual

property (as defined in section 23I of the ITA). Provided that certain requirements are met, certain transactions with a SA headquarter company (as defined in the ITA) may also be exempt from the TP rules.

As noted earlier, it is the stated intention of the SARS to provide an update to PN2 and PN7, following the amendments to the legislation, however, at the time of this publication these had not been released. The DTC also suggested that these Practice Notes should be updated. Although SARS released a draft Interpretation Note on financial assistance, which details onerous documentation requirements that taxpayers need to adhere to where they have related-party financial assistance, there are still several uncertainties regarding this area of TP that must be addressed.

As a further measure against base erosion, an interest WHT was introduced with effect from 1 March 2015. The introduction of this tax means that non-residents earning interest from a SA source will be subject to SA WHT at a rate of 15% subject to treaty relief.

Another rule that has been introduced recently, section 23M of the SA ITA, also effective from 1 January 2015, provides for limitations on the aggregate deductions for interest incurred by a SA borrower which is in a controlling relationship with the foreign lender where the interest is not subject to SA tax in the lender's hands. The limitation also applies where the lender (which is not in a controlling relationship with the borrower) obtained the funding from a person that is in a controlling relationship with the borrower. The interest limitation is calculated based on a percentage of the debtor's 'adjusted taxable income', which approximates to the tax equivalent of the accounting EBITDA. The percentage is currently 39%, but can change depending on the current average repo rate. There is a broadly similar restriction in section 23N of the Act which applies to interest on debt that arises from reorganisation and/or acquisition transactions that took place on or after 1 April 2014.

In terms of the current legislation, a new service WHT will be introduced in 2016. However, based on preliminary high level discussions with National Treasury, it is possible that the legislation in connection with the new WHT on service fees may be repealed and it would be replaced with a reporting requirement in relation to service fees paid to non-residents. At this stage, there is not yet final clarity on how National Treasury will approach this matter. However, an important change to the requirement to file tax returns for the current year to 28 February 2016, is that non-resident service provider who carry out their service in or partly in South Africa, are required to register for tax and file tax returns, even if, in terms of a relevant tax treaty, SA has no taxing rights. Historically, there was also a requirement for the non-resident to have a permanent establishment (PE) in SA before this filing requirement was triggered. This PE exclusion has been deleted from the provisions calling for tax filings.

Penalties

Section 31 of the SA ITA requires taxpayers to determine the taxable income, if different from that reported, which would arise from an arm's-length transaction. This places emphasis on self-assessment of the terms and results of the transactions with related parties and has implications for prescription and non-disclosure. It also allows the SARS to recharacterise transactions for TP purposes and apply a whole-of-entity approach. This self-assessment requirement is also conveyed in the questions found in the annual income tax return.

The Commissioner can also levy additional tax on TP adjustments, which include interest on unpaid tax and penalties for underestimation of provisional tax. In terms of the Tax Administration Act, an understatement penalty may be applicable. The amount of this understatement penalty is determined with reference to the degree of care or lack thereof that resulted in the understatement, and to the extent the taxpayer made voluntary disclosure or whether the taxpayer acted obstructively. This penalty ranges from 0% to 200%.

The SARS may remit this understatement penalty if the taxpayer made the requisite disclosure by the time the income tax return was due, and is in possession of a qualifying tax opinion. A qualifying tax opinion is one written by a registered tax practitioner, being a member of an appropriate professional body (e.g. the SA Institute of Chartered Accountants) and being appropriately registered as a tax practitioner with the SARS, where the opinion supports the filing position taken by the taxpayer. It follows that where PwC provide a report on the TP documentation prepared by the taxpayer or otherwise confirm the appropriateness of the TP documentation prepared by PwC, subject to meeting the requirements, it may be possible to use such opinion to reduce the potential for penalties in terms of the Tax Administration Act. Please note that the Tax Administration Act is a fairly new piece of legislation and there is currently some uncertainty on how the SARS will, in practice, apply certain provisions of this Act.

Documentation

In terms of the SA ITA, there is no statutory obligation to prepare or submit a TP policy document (TPD). However, the Commissioner may specifically require a taxpayer to furnish information for the purposes of Tax Administration. Such information may include a TPD, if available.

The SARS have outlined their recommendations for supporting documentation for TP policies in PN7. PN7 (which is based on the old TP legislation) provides guidance on the nature of documentation required; however, it does not lay down any hard and fast rules for compiling documentation, but recommends that the documentation should address the following:

- Identification of cross-border transactions between connected persons falling within the scope of section 31 (affected transactions).
- A description of the nature and terms (including prices) of all the relevant affected transactions.
- A functional analysis.
- The reasons why the choice of method was considered to be the most appropriate to the relevant affected transactions and to the particular circumstances. This includes an explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's-length principle.
- An appraisal of potential comparables and information (i.e. commercial agreements with third parties, financial information, etc.) relied on in arriving at the arm's-length terms.
- Details of any special circumstances that have influenced the price set by the taxpayer.

In 2013, the SARS also released a draft Interpretation Note on financial assistance. The draft Interpretation Note on financial assistance details onerous documentation requirements that taxpayers need to adhere to where they have related-party financial assistance.

In addition, the income tax return (ITR14) requires taxpayers to list the rand value of all affected transactions as defined in section 31 where the taxpayer received/earned foreign income and/or incurred foreign expenditure. The ITR14 also requires taxpayers to respond to the following questions (in a yes or no format):

- Does the company have TP documentation that supports the pricing policy applied to each transaction between the company and the foreign connected person during the year of assessment as being at arm's length?
- Did the company conduct any outbound transaction, operation, scheme, agreement for no consideration with a connected person that is tax resident outside SA?
- Did the company transact with a connected person that is tax resident in a tax haven/low-tax jurisdiction?
- Did the company make a year-end adjustment to achieve a guaranteed profit margin?

You will appreciate that the answers to these questions are used by the SARS for the purposes of risk profiling and therefore, these responses require careful consideration as they could result in a query from the SARS.

Although there are no specific penalties for not complying with TP documentation requirements in SA, penalties can be avoided/reduced by preparing TP documentation.

In the December 2014 report, the DTC recommended that documentation requirements should be introduced in line with the new OECD Guidelines on documentation. The DTC agreed with the OECD's recommendation that countries should adopt a standardised approach to TP documentation that follows a three-tiered structure consisting of a master file, a local file and country-by-country reporting and they suggested that this should also be adopted in SA. The DTC is of the view that 'this approach will encourage a consistent approach to TP documentation in different countries which will help contain the cost of global TP documentation'.

The DTC also recommended that it should be compulsory for large multinational businesses with turnover in excess of 1 billion South African rand (this threshold is substantially lower than the threshold of 750 million euros (EUR) suggested by the OECD) to prepare documentation based on the three-tier approach. The DTC also recognised that small and medium sized enterprises (SMEs) should not be required to produce the same amount of documentation that might be expected from larger enterprises. However, SMEs should be obliged to provide information and documents about their material cross-border transactions upon a specific request of the tax administration in the course of a tax examination or for TP risk assessment purposes.

In the context of country-by-country reporting, SA, along with other emerging economies, have stated that they are of the view that the country-by-country report should require additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. The view is that such information would be needed to perform risk assessments

where it is found challenging to obtain information on the global operations of multinationals.

The current expectation is that new legislation may be introduced in 2015 to bring SA's documentation standards in line with the new three-tier approach suggested by the OECD.

Transfer pricing controversy and dispute resolution

Burden of proof

In terms of section 31 of the SA Income Tax Act, the burden of proof lies with the taxpayer to demonstrate that the TP policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's-length standard.

Tax audit procedures

As indicated earlier, TP is one of the SARS and ATAF's key focus areas.

The SARS follows the OECD Guidelines in conducting TP investigations. However, going forward, it is likely that the SARS will also consider the guidance from the United Nations Practical Manual on Transfer Pricing for Developing Countries (UN Manual). The UN Manual states that while the OECD Guidelines have been particularly useful in providing a conceptual understanding of what is the nature of the arm's-length principle, there are instances when the OECD Guidelines fail to address the more practical aspects of how to apply the principles.

All multinationals are potential targets for a SARS audit – inbound investors as well as SA-based groups. Companies that fall within the provisions of section 31 of the SA Income Tax Act should take TP seriously and develop and maintain properly documented and defensible TP policies. Such documentation must be contemporaneous and regularly updated. Previously, the SARS' practice was to accept that documents can be updated only every three years, or for changes in the operations. Currently, we recommend that benchmarking for non-core services be updated at least every three years. Furthermore, on the basis that tax is viewed as an annual event, taxpayers need to ensure the documentation is reviewed annually.

The SARS also prefers the SA taxpayer to be the tested party, even though it may not be the least complex party to the transaction. The TP document must list every cross-border transaction entered into by the taxpayer, even though the TP document may not deal with a specific transaction in detail. This ensures that the taxpayer satisfies the requirement for full disclosure in its TP documentation.

The SARS is actively auditing taxpayers on their TP and has indicated that it will place greater scrutiny on multinationals that have connected-party entities situated in low-tax jurisdictions. This line of enquiry tends to combine a challenge on residence of the low-taxed foreign entity, together with questions on the TP. We have also seen the SARS issue TP questionnaires to multinationals to obtain information regarding their transfer prices. The focus of these is on comparability and characterisation of transactions.

Taxpayers under investigation by SARS are also seeing more questions around their overall value chain. This approach is in line with the BEPS developments. SARS is starting to apply some of the new OECD guidance (for example, the new draft chapter on Intellectual Property) in practice to current audits, even though the new guidance has not yet been finalised by the OECD. SA taxpayers should therefore take cognisance of the new developments and assess the impact thereof on their operations.

As indicated in the SA chapter of the UN TP manual, the lack of SA comparable information remains a constraint for SARS and taxpayers. The DTC therefore indicated that "it is important that SARS builds a database of comparable information".

The SARS, as in SA generally, is experiencing resource constraints, which means many of the audits commenced take a long time to conclude. In addition, where transactions are with African countries that do not have a TP regime or an appropriate DTA in place, solutions through the normal channels of mutual agreement procedures (MAPs) are simply not available or, where they are, the process is very cumbersome with limited chance of success. As noted earlier, the DTC has recommended that SARS should increase the capacity in their TP team.

Advanced pricing agreement
Paragraph 16.2 of Practice Note 7 (PN7) provides that due to various factors, the APA process will not be made available to SA taxpayers. However, based on our recent discussions with the SARS, we understand that they are serious about introducing an APA programme and that it could well be introduced in SA within the next one to three years, depending in resource criteria and constraints.

Case law
Since the introduction of TP rules in 1995, there have been no TP court cases in SA.

Given the lack of court cases on TP, few advocates and judges have knowledge of TP. For this reason, taxpayers sometimes prefer to settle cases with the SARS rather than going to court, or where available under the relevant treaty, to initiate competent authority claims.

In the event that a matter is brought to court, under the SA Constitution, the courts are bound to consider international precedent (i.e. foreign case law) in the event that no local precedent is available. However, foreign case law is only of persuasive authority and is not binding on the SA courts.

Dispute resolution alternatives
There are various alternatives available to taxpayers to resolve disputes with the SARS. Specifically, taxpayers can:

- invoke MAPs
- enter into a unilateral agreement with the SARS without corresponding tax relief in another tax jurisdiction, or
- take the dispute to court.

Most, if not all, disputes in SA have been settled by the unilateral settlement procedure.

Comparison with OECD Guidelines

SA is not a member of the OECD, but it is an enhanced engagement country. SA actively participates in, and provides input to, OECD discussions and discussion papers. SA follows the OECD Guidelines and the 2010 changes to the TP guidelines issued by the OECD are being applied by the SARS in their TP audits. As noted above, in practice, SARS is also starting to apply some of the new OECD guidance (for example, the new draft chapter on Intellectual Property) to current audits, even though the new guidance has not yet been finalised by the OECD. In addition to references to the OECD Guidelines, the UN practice manual should also be considered as a guide. This has the potential of creating issues in the event of a conflict between interpretations contained in the UN manual and the OECD Guidelines.

Having said this, the SA appendix to the UN practice manual gives a good summary of how the SARS approaches its TP audits. In this regard, per the SA country chapter in the UN practice manual, the SARS states that it favours a more holistic approach to establishing whether or not the arm's-length principle has been upheld. By seeking to understand the business model of taxpayers across the value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intragroup transactions and agreements, etc., it is evident that the SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate arm's-length level of profit has been achieved. This approach is in line with the approach being taken by the OECD in terms of the various base erosion and profit shifting initiatives.

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Spain

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Overview

During the past few years, the Spanish Tax Authority (STA) has been increasing, and continues to increase, its awareness of, and attention to, transfer pricing (TP). During 2014, the Spanish government worked on a comprehensive tax reform covering a number of different taxes including corporate income tax. Precisely, as of 28 November 2014 the new Corporate Income Tax Law (CITL) (Law 27/2014, 27 November 2014) was published in the Official Spanish Gazette. The new CITL contains the new regulations governing the corporate income tax. The regulation of transactions carried out between related parties is now reflected in Article 18 of the new CITL, which maintains, in general terms, the obligation to value related-party transactions according to the arm's-length principle, the obligation of the taxpayer to prepare TP documentation and the specific penalty regime applicable in the event of infringements.

Country	**Spain**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	As from the end of the voluntary return or assessment period in question
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Depends on TP adjustments

Spain

Introduction

The legislation enacted in 1995, the statutory regulations approved in 1997 and the new modifications effective as of 1 January 2015, include the general principles for dealing with transactions between related parties. They also state the procedure to be followed by taxpayers seeking advanced pricing agreements (APAs) and the basic procedure to be followed by tax auditors in the field for reassessing the transfer price agreed between related parties.

Article 16 of the Spanish Corporate Income Tax Law (CITL) was modified by Law 36/2006, which came into force on 1 December 2006, affecting transactions carried out in fiscal years starting after that date. The legislation provided that transactions between related entities and persons, including domestic as well as cross-border transactions, should be valued and declared at arm's length for tax purposes. This set of TP rules and regulations were closely aligned with international best practices, as provided in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organisation for Economic Co-operation and Development (OECD Guidelines) and the European Union Joint Transfer Pricing Forum (EUJTPF). Previous to that legislation, making adjustments to related-party prices was a power of the Spanish Tax Authorities (STA) only. It is also important to note that the modifications that were introduced by that time were included as part of the Bill of Measures against Tax Fraud, which highlighted the level of importance given to TP in Spain.

The language introduced in the new CITL of 28 November 2014 gives the regime governing intragroup transactions more rationality and proportionality, limits the shareholding threshold, simplifies the TP documentation obligations for certain companies and slightly softens the TP special penalty regime, among other measures.

Legislation and guidance

Since 1 January 2015, Spain's legislation concerning TP is contained in Article 18 of the new CITL and in Article 41 of Law 35/2006, modifying the Personal Income Tax Law (PITL).

The legislation provides that for corporate tax purposes, related-party transactions should reflect arm's-length pricing. In order to demonstrate that the intragroup transactions performed are in accordance with the arm's-length principle, the taxpayer has to maintain at the tax administration's disposal, the TP documentation as developed by the Corporate Income Tax Regulations (CITR). These requirements should be subject, according to the law, to the principles of proportionality and sufficiency.

Regarding the latter, the Spanish government is currently working on the draft CITR, which is expected to be approved during the first semester of 2015. Furthermore, Spain's government has announced its intent that the coming CITR will include the obligation for multinationals to provide information (data) relating to corporate taxpayers in each jurisdiction in which they operate, in line with the OECD's base erosion and profit shifting (BEPS) initiative. However, details relating to the extent of the obligation, to what corporate taxpayers this will apply, and how this information will be shared with other tax administrations has yet to be clarified.

The Spanish TP rules are consistent with the OECD Guidelines as well as with the recommendations of the EUJTPF. Law 27/2014 establishes in its preamble that one of the main objectives of the introduction of this law was precisely to align Spain's TP rules and regulations with the international practices on this subject and, in particular, with the OECD Guidelines and the recommendations of the EUJTPF. Furthermore, the preamble of Law 27/2014 specifically mentions that the new rules should be interpreted and understood in accordance with the OECD Guidelines and the EUJTPF recommendations. In other words, the fundamental aspects such as the arm's-length standard, the comparability requirements and the alternative TP methods are substantially the same under the Spanish TP rules as in the OECD Guidelines.

The new Spanish TP legislation includes the five TP methods, being consistent with the language included in the OECD Guidelines. Also, the new CITL has introduced the elimination of the hierarchy of the methods to be used in arm's-length valuation and incorporated the 'most appropriate method' approach. It is specified that the TP method selection should be based on, among other circumstances, the nature of the transaction, the availability of reliable information and the level of comparability between controlled and uncontrolled transactions. Also, once it is properly justified that the valuation methods envisaged are not applicable, the new CITL introduces the possibility of using other methods or valuation techniques, which are consistent with the arm's-length principle.

One of the main changes incorporated for tax periods beginning after 1 January 2015 is the increase on the threshold for considering two entities as related companies. Regarding the shareholding link, the law considers relationship when a company controls, directly or indirectly, 25% of the shares or more in the other company (the previous threshold was only 5% or even 1% for public companies).

Article 41 of the PITL establishes, as a general principle, that transactions between related persons or entities will be priced in accordance with the arm's-length principle. The procedure for establishing the arm's-length value and, where necessary, for substituting the value declared in a taxpayer's return is set out in Article 18 of the CITL.

The procedure to be followed by tax authorities when seeking to apply the arm's-length principle through the course of a tax inspection is stated in Article 16 of the CITR. A brief description is as follows. First, if the other party of the related-party transaction has also been taxed under the CITL or PITL, it is notified by the tax authorities that the transaction has been placed under scrutiny. This notification explains the reasons for the adjustment to the company's profit and the methods, which could be used in determining the arm's-length value. The related party has 30 days to present any facts or arguments that it believes are pertinent to the matter.

Having examined both related parties' arguments, and immediately prior to preparing the document in which the arm's-length value shall be established, the methods and criteria to be taken into account are made available to the parties. The parties then have 15 days in which to formulate additional arguments and whatever documents and evidence they deem appropriate.

Either party has the right to dispute the outcome of the proceedings, in due course. If they do not, the arm's-length value established by the tax authorities becomes effective for all tax periods under assessment in accordance with Article 18 of the CITL. If the outcome is indeed contested by either of the related parties, its application is suspended, pending a final decision. In the meantime, tax assessments are deemed to be provisional.

Regarding the verification of related-party transactions, the new language included in the CITL through Article 18 excludes the possibility of seeking a counter valuation by an appraisal expert. On the other hand, the new TP regime includes the possibility for the taxpayer to perform the regularisation itself, according to the terms included in the CITR. Furthermore, in addition to the verification of the arm's-length values, the new CITL appears to empower the STA to establishing the qualification or the nature of the intragroup transactions.

Finally, it is worth mentioning that the new Spanish TP regime establishes that a valuation made in accordance with the rules on related-party transactions is non-pervading, i.e. applicable exclusively to corporate income tax, personal income tax and non-resident income tax. This implies that the arm's-length value determined has no impact in relation to other taxes and vice versa.

The Spanish CITL includes provisions dealing with APAs. APAs can be unilateral or bilateral, and normally refer to pricing arrangements, but can also cover research and development (R&D) expenses, management fees and thin capitalisation.

Penalties

With regard to the documentation requirements, the provision of incomplete, inaccurate or false documentation or where the declared values do not coincide with the values derived from the documentation would imply penalties.

The penalty applied depends on whether or not the tax administration assesses a TP adjustment:

- If there is no adjustment, a penalty of EUR 1,000 is imposed for each missing, inaccurate or false data item; or EUR 10,000 for a collection of missing, inaccurate or false data items. This penalty has as maximum limit the lowest of the following:
  - 10% of the total amount of the controlled transactions; and
  - 1% of the turnover.
- If there is an adjustment, a penalty of 15% of the adjusted amount is imposed.

A special procedure exists for imposing penalties, which is independent of the normal tax audit procedure. Such a procedure may be commenced by the tax inspector or by a special officer assigned by the chief tax inspector. The tax inspector must provide all relevant data or proof to justify the penalty being imposed. The taxpayer may formulate allegations and present its consent to, or disagreement with, the proposed penalty. The penalty is automatically reduced by 30% if the taxpayer agrees with the penalty proposal.

The taxpayer may appeal against the proposed penalty without necessarily paying or guaranteeing the amount of the penalty being imposed.

Documentation

From 19 February 2009 onwards, Spanish taxpayers have been required to produce group-level and taxpayer-specific documentation for each tax year.

In this sense, Article 18.3 of the CITL establishes as a general rule that related persons or entities must keep available for the tax authorities such documentation as from the end of the voluntary return or assessment period in question. The documentation follows the principles contained in the European Union Code of Conduct on TP documentation.

As it was mentioned previously the Spanish Government has expressed its intention to adopt in the upcoming new CITR the country-by-country reporting requirements as included in Action 13 of the OECD/G-20 BEPS Action Plan.

The Spanish TP regime requires taxpayers to produce, at the request of the tax authorities, documentation, which, in turn, is divided into two parts:

- Documentation relating to the group to which the taxpayer belongs.
- Documentation on the taxpayer itself.

CITL also establishes the following instances in which there is no documentation requirement for related-party transactions:

- Transactions carried out within a consolidated Spanish fiscal group.
- Transactions carried out by economic interest groups and temporary business associations.
- Transactions involving the purchase or sale of publicly traded shares.
- Intragroup transactions carried out with the same related party, which do not exceed the total amount of EUR 250,000.

At the same time, the CITL establishes reduced documentation obligations for (i) related persons or entities with net revenues below EUR 45 million (the previous limit was EUR 10 million). There are certain exceptions to the simplified content rule, such as business transfer operations, transfers of unlisted securities, operations involving real property or intangibles; and (ii) individual persons. Finally, it should be noted that documentation is required for transactions with entities, related party or not, resident in tax havens.

Burden of proof

The statutory regulations state that taxpayers should value transactions with their related parties at market prices and also indicate how that value has been calculated (Article 18 of the CITL and Article 41 of the PITL).

Should any discrepancies regarding the suitability of the transfer prices arise in the course of a tax review, it is in the taxpayer's interest to present as much evidence as possible in support of its prices. Detailed evidence presented by the taxpayer helps reduce the likelihood of the authorities proposing an adjustment and imposing penalties. For these reasons, it is necessary that the taxpayers comply with the obligation to produce documentation.

Although initial burden of proof lies on the taxpayer, it is relevant to mention that any tax administration review in an audit ending in an adjustment of the prices applied by the taxpayer should also follow the OECD methodology and is, therefore, subject to scrutiny from that perspective.

Risk transactions or industries

Transfer pricing is an area of increasing interest for the STA. So far, they have not concentrated on any particular industry, although emphasis has been placed on the automobile, computer/software and pharmaceutical industries.

Special attention has been directed towards management fees, royalties and loans. In addition, the STA is quite sensitive to so-called business transformations and may assert that a permanent establishment (PE) exists of a foreign party to which significant business functions and risks have been theoretically transferred.

Regarding the existence of a PE, the Spanish Supreme Court has confirmed the need for robust justification and adequate arm's-length remuneration of TP policies as a useful means to mitigate the adverse tax consequence of any PE challenge raised by the STA in the context of business restructurings. These decisions also reinforce the need to watch carefully how the operations of both non-resident and Spanish companies are managed, specifically with respect to their independence and autonomy.

The section of the legislation dealing with management services is now included within a more general definition of services. The deduction of expenses for services provided by related parties is subject to the condition that the services provided produce, or can produce, an advantage or benefit to the receiver. According to the new CITL no mention is made to the deductibility of expenses regarding services, although the requirements are the same.

Where it is not possible to separate the services provided by the entity (i.e. directly charging), it is possible to distribute the total price for the services between all beneficiaries of the services in accordance with rational distribution criteria. These criteria need to take into account not only the nature of the service but also the circumstances surrounding the provision of services as well as the benefits obtained (or that can be obtained) by the beneficiaries of the services.

The deduction of expenses derived from cost-sharing arrangements (not only related to R&D) between related parties is subject to the following:

- The participants to the arrangement must be able to access the property (or the rights to the property having similar economic consequences) of the resulting assets or rights being subject of the cost-sharing arrangement.
- The contribution of each participant must take into account the anticipated benefits or advantages that each participant expects to obtain in accordance with rational criterion.
- The agreement must contemplate variations in circumstances and participants, establishing compensatory payments and any other adjustments that may be considered necessary.
- The agreement must comply with the documentation requirements to be established at a later date.

Regarding management fees (and as noted), the STA expects to see the application of rational and continuous cost-allocation criteria and actual evidence of the benefits received from the services.

Transfer pricing controversy and dispute resolution

Resources available to the STA

In 2013, a specialist unit dealing with TP and international tax issues was established. This unit is named the National Office of International Taxation (ONFI) and will be in charge of complex transactions, hybrids and aggressive tax planning. The regional and national tax offices, which are responsible for the larger companies or multinational companies, normally deal with TP issues during the course of a general tax audit.

In addition, significant resources are being made available to improve inspectors' ability to successfully undertake audits, and active training is taking place. Tax inspectors currently act on their own, although this does not rule out the possibility that they could receive assistance from in-house experts. Additionally, tax inspectors are able to exchange information under the principles established in the OECD Model Tax Convention and in the European Directive 2004/56 on Mutual Assistance.

Availability

Annual accounts (including the notes to the accounts and directors' report) are officially registered and therefore publicly available. Databases containing detailed financial information of Iberian companies are available. In certain industries (e.g. the pharmaceutical industry), more detailed information concerning product pricing and profit margins may be obtained. The STA has a natural tendency to employ local comparable companies for benchmarking purposes.

The STA has confirmed the use of databases such as AMADEUS and SABI (the Bureau Van Dijk database containing companies located within the Iberian Peninsula).

Tax authorities have also confirmed that they do not use secret comparables, although very often they request information from other companies that operate in the same sector. This information may be requested individually for specific transactions or in a general manner. In some cases, such information has been used by the authorities to justify a TP reassessment.

Tax audit procedures

Spanish tax inspectors operate on three levels: national, regional and local. National and regional specialist units are responsible for all tax affairs dealing with companies or groups of companies that may deserve close attention for reasons such as size, importance of operations, a distinguished reputation in an economic sector, volume of sales, etc. Such companies and groups are subject to tax audits on a recurring basis. Smaller companies are dealt with at the local level. Transfer pricing issues, historically, were considered as part of a general tax audit and not the subject of a special investigation by itself. However, with the current legislation, TP audit activity has increased significantly. Numerous audits have been initiated whose scope is limited to an analysis of the arm's-length nature of inter-company prices.

In principle, the STA is empowered to collect all the information and data necessary to conduct a tax audit. In general, taxpayers are obliged to provide the tax authorities with such information. Failure to present the accounting registers and documents, which companies are required to keep by law, or failure to provide any data, reports, receipts and information relating to the taxpayer's tax situation, may be considered as resisting or hindering the tax audit.

In general terms, all taxpayers are obliged to present, by law or under a specific request by the tax authorities, any relevant information for tax purposes they may have with respect to third parties, in connection with business, financial or professional relationships held therewith. Any information presented to, or obtained by, the tax authorities is considered to be confidential and can be used only for tax purposes and may not be disclosed to third parties, except in those cases stated by law.

Each inspector is assigned a Personal Confidential Tax Audit Plan for the period, which includes all the taxpayers to be audited by his/her team.

Each taxpayer is entitled to be informed upon commencement of a tax audit, the nature and scope of the audit about to take place, as well as its rights and obligations during the course of such proceedings. The tax audit proceedings must be concluded within 12 months, although, under certain circumstances, this period may be extended by an additional 12-month period.

Inspections are normally conducted at the company's main offices or at the tax authorities' offices.

The procedure is deemed to be completed when the tax auditor considers that all the necessary information required to put together a reassessment proposal has been obtained. Prior to the tax auditor drawing up his/her proposal, the taxpayer is given the opportunity to formulate allegations. A tax inspection usually concludes with a reassessment proposal, which the taxpayer can accept or reject in part, or in whole.

Tax inspectors must file a separate TP assessment, distinct from any assessments related to other income-tax obligations. The contents of the TP assessment must include a justification of the arm's-length value as determined by the tax inspector and an explanation of how the arm's-length value was determined.

In the event that the taxpayer does not accept the inspector's proposal, a writ of allegations may be presented to the inspector's superiors. Based upon this writ and the tax inspector's extended report, the superior officer can confirm, modify or cancel the additional assessment.

If the taxpayer is dissatisfied with this decision, an appeal may be filed with the office or directly with the *Tribunal Económico Administrativo Central* (TEAC). At this stage of the procedure, the additional assessment must be paid or guaranteed. An appeal against the decision passed by the TEAC may be filed with the ordinary courts of justice.

Joint investigations

There is nothing in the Spanish CITL to prevent the authorities from joining with authorities of another state to establish a joint investigation of a multinational company or group. In fact, on more than a few occasions the STA has taken part on in such procedures.

Advance pricing agreements (APAs)

The CITL provides taxpayers with a statutory right to seek an APA. The general regulations are contained in paragraph nine of Article 18, and the CITR regulates in detail the procedure for processing and deciding on and APA between related persons or entities, whether of a unilateral nature with the STA, or bilateral or multilateral, involving other tax authorities.

The tax inspection department of the Spanish National Tax Agency (AEAT) is the administrative body in charge of dealing with APA requests. The procedure for applying for an APA is a two-step process. Step one is a prefiling waiting period of one month, after which the taxpayer is informed of the basic elements of the procedure and its possible effects. Step two is the actual filing, which takes approximately six months in the case of unilateral APAs.

The information provided to the tax administration in the prefiling and filing stages is used exclusively within the context of the APA, and is applicable only for such purposes. Regarding its affects, the APA could cover four tax years following the signature date and could be rolled backwards as long as those fiscal years are still opened to audit but have not yet been revised by the STA. If the taxpayer's proposal is not approved, the taxpayer has no right to appeal the decision. Taxpayers often file an alternative APA after negotiating any points of contention of the initial proposal with the tax authorities.

The STA has shown a positive response in the processing and ruling of APAs. Furthermore, providing that no significant changes in the underlying conditions of the APA occur, a taxpayer may request an APA renewal.

Limitation of double taxation and competent authority proceedings

In principle, when a TP adjustment affects transactions between a Spanish company and a non-resident, the mechanisms laid down in the relevant double taxation treaty (DTT) should be applied. Where the non-resident is within the European Union, the provisions of the Arbitration Convention relating to the elimination of double taxation (EC Directive 90/436) can be applied.

In relation to the mutual agreement procedure (MAP) arising from the mechanisms laid down in the DTTs or the provisions of the European Union Arbitration Convention, the Royal Decree 1794/2008 of 3 November, approving the regulations on direct taxation-related MAPs, establishes different regimes (and the phases within each regime), depending on whether the procedure is initiated by the Spanish or the foreign competent authorities, and depending on which tax administration (Spanish or foreign) has made (or makes) the assessment. According with the Non-Resident Income Taxation Law, RDL4/2005 (NRITL), the MAP could suspend the execution of the assessment at the request of the taxpayer (properly guaranteed) and would entail the paralysation of the late interest payment accrual.

Liaison with customs' authorities
In practice, there is little communication between the income tax and the customs' authorities, despite the fact that there is nothing to prevent an exchange of information. Interestingly, TP adjustments for income-tax and corporate tax purposes do not necessarily need to be reflected in returns filed for customs or for any other indirect taxes.

Also, the new CITL has established that customs' valuation and TP valuation for corporate income-tax purposes are independent and not binding on each other.

Secondary adjustment
Secondary adjustment is still applicable according to the new CITL, although, following a Spanish Supreme Court's judgment regarding certain provisions on the CITR, the treatment of the valuation differences in transactions between shareholders and entities (or vice versa) have been incorporated into the new CITL.

It is relevant to mention that the new CITL has also introduced formally the restitution of the excess (what the OECD refers to as 'repatriation') in order to avoid the secondary adjustment. This restitution will have no other tax consequences for the taxpayers.

Thin capitalisation
On 30 March 2012, the Spanish Government announced the 2012 budget. Together with the budget announcement, the Government approved Royal Decree-Law 12/2012, which introduced a number of relevant changes in the corporate tax area, among which was the new thin capitalisation regime.

The Spanish Government has followed the trend set by other European governments and has introduced an interest expense-capping rule that replaces the previous thin capitalisation rules in Spain. The interest expense-capping rule, which applies to both related-party and unrelated-party debt, limits the tax relief for net interest expense to 30% of the taxpayer's earnings before interest, taxes, depreciation and amortisation (EBITDA). For entities being part of a tax consolidation group, this 30% limit applies to the level of the tax group.

Interest disallowed under the interest expense-capping rule can be carried forward 18 years. On the other hand, when the interest expense in a given year is below the 30% limit, the new rule allows this unused capacity to be carried forward five years.

The interest expense-capping rule does not apply if either: (i) the net interest expense does not exceed EUR one million; (ii) the taxpayer is not part of a group of companies (as defined in Spanish company law); or (iii) the taxpayer is a financial institution.

New anti-debt-push-down legislation
The aforementioned Royal Decree includes specific language in order to deny the deductibility of interest from debts with group companies (whether resident in Spain or not) when the debt has been used to acquire shares in other group companies, unless the taxpayer is able to prove that the transaction is supported by valid economic reasons.

As potentially non-tax driven transactions, the explanatory memorandum cites group restructurings directly connected to an acquisition from a third party, or cases where there is a true management in Spain of the entities acquired.

Legal cases

Several cases over the years have established important principles for dealing with TP issues. Some of the most important cases are summarised below. They provide general principles on various points (arm's-length definition, comparability analysis, internal comparables and necessary documentation for deducting intercompany service charges).

Decisions from the Supreme Court represent the final judgment in a Spanish tax case. On the other hand, the TEAC (an administrative body included within the Tax Administration but acting independently of the tax audit authorities), represents the first instance and has created a solid administrative doctrine that is consistently applied.

- TEAC resolution (12 July 2007): the establishment of a comparable uncontrolled market price is extremely difficult and requires that:
  - the same geographical market is used as a reference
  - similar or identical goods be compared
  - the volume of transactions compared is identical
  - the comparison be made at the same stage of the production/distribution process, and
  - the transactions being compared are carried out within the same period of time.
- Supreme Court decisions about management fees (12 February 2012; 20 February 2012; 29 March 2012; 30 May 2013): the burden of proof lies with the taxpayer. The taxpayer is therefore required to prove that:
  - the services have in fact been provided
  - the service provider incurred expenses when rendering such services, and
  - the service provided added economic value to the related entity receiving such services.
- Supreme Court decision about PE (12 January 2012): the Spanish Supreme Court delivered its decision on a case concerning a Swiss principal company that manufactured and distributed its products in Spain through a Spanish subsidiary. The decision arguably confirms the approach of the 'manufacturing dependant agent' and confirms the existence of a PE in Spain. Also, the Supreme Court confirms the view of the National High Court that, once a PE is deemed to exist because of the manufacturing activities, the profit of the PE is not only to include the profit attributable to the manufacturing activity but also the profit obtained on the sale of products.
- TEAC resolution about PE (15 March 2012): a non-resident entity was part of a larger related group that included a Spanish subsidiary. It appears that the taxpayer intended to utilise a principal and commission agent structure and claim that the non-resident company should not be subject to taxation in Spain. However, the TEAC decision relied heavily on the facts and determined that the 'operational reality', i.e. the substance of the activities, was that the non-resident company had a PE in Spain. This decision demonstrates the STA's keen focus on the underlying substance when analysing PE issues.
- Finally, there are several Supreme Court decisions about customs' regulations, internal comparables and purchase of active ingredients (11 February 2000; 15 July 2002; 4 December 2007; 22 January 2009; 30 November 2009).
- There are several judgments regarding the non-deductibility of the financial expenses derived from intra-group loans used to finance certain transactions carried out within a group of companies (Supreme Court decision of 27 September 2013 and National Court decision of 2 February 2011), where a requalification of the loans was carried out in line with the new language included in the CITL.

Comparison with OECD Guidelines

Spain's TP rules and regulations are consistent with the OECD Guidelines as well as with the recommendations of the EUJTPF. This comes as no surprise, given that Law 27/2014, which enacts the present TP rules, together with Royal Decree 1793/2008, establishes in its preamble that one of the main objectives of the introduction of this law was precisely to align Spain's TP rules and regulations with the international practices on this matter and, in particular, with the OECD Guidelines and the recommendations of the EUJTPF. Furthermore, the preamble of Law 27/2014 specifically mentions that the new rules should be interpreted and understood in accordance with the OECD Guidelines and the EUJTPF recommendations.

In other words, the fundamental aspects such as the arm's-length standard, the comparability requirements and the alternative TP methods are substantially the same under the Spanish TP rules as in the OECD Guidelines.

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Sri Lanka

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Overview

The Sri Lanka economy is characterised by an increasing degree of interdependence with foreign capital and overseas product markets. Investment in Sri Lanka by foreign investors is actively promoted, particularly in manufacturing for export, by the Government. Consequently, extensive relationships of mutual control and management among many foreign and Sri Lankan companies now exist. These relationships including the widespread group formation that the corporate sector in Sri Lanka has witnessed have necessitated the introduction of specific transfer pricing (TP) legislation in Sri Lanka. TP in Sri Lanka is at an evolving stage but that the topic of TP is receiving special attention of the Sri Lanka Inland Revenue Department (IRD) was demonstrated, when in March 2015 the IRD issued regulations requiring an auditor certification in relation to transaction(s) with associated undertakings, to be filed with the tax return, commencing from the tax year 2015/2016.

The Sri Lanka income tax statute, Inland Revenue Act No. 10 of 2006 (IRA), incorporates the specific provisions in regard to TP with a view to providing a statutory framework to enable the computation of reasonable profits in Sri Lanka from business carried on in Sri Lanka. These provisions focus on the application of the arm's-length pricing test to the profits or loss arising from international transactions between associated undertakings as well as from domestic transactions between resident associated undertakings.

The arm's-length methodologies to be applied, the tests of control of associated undertakings and the documentation to be maintained to satisfy TP requirements were prescribed in the regulations published in the Sri Lanka Gazette Extraordinary No. 1823/5 of 12 August 2013. This was followed by the issue of 'IRD Transfer Pricing Explanatory Guidelines' (IRD Guidelines) that explained the concepts of arm's-length price and the TP methodologies, in addition to providing an enhanced understanding of comparability and supply chain analyses as well as on specific transactions relating to intragroup services and financing, intangible properties etc.

The IRD has initiated administrative measures for the implementation of the TP regulations with the setting-up of a TP Regulations Unit and the appointment of TP Officers (TPOs). Currently, TP audits are carried out as part of the general audit programmes. The in-depth examination of transactions with associated undertakings, however, appears to be increasing and, soon it is expected that the IRD will be

focussing on specific TP audits of the taxpayer's business activities. In that background, greater responsibility is now placed on the taxpayer in Sri Lanka to prepare for compliance with TP regulations and to keep contemporaneous documentation in English evidencing that transactions with associated undertaking are based on the arm's-length standard.

Country	**Sri Lanka**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	When the return filed, from tax year 2013/2014
Must TP documentation be prepared in the official/local language?	English
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Twice the adjusted tax due, in addition to late payment penalty

Introduction

Sri Lanka operates a tax system based on self-assessment where the onus of proof rests with the taxpayer. Every taxpayer should compute his taxable income from all sources on a current year basis and file a tax return on or before 30 November immediately following the end of a tax year. Where the IRD rejects a return, under the rules of prescription, an assessment has to be made within 18 months from the filing date (30 November) and, when the tax return is not filed by the due date, an assessment should be made within four years from the end of the filing due date. An amendment to the IRA, awaiting enactment by Parliament, extends the period of prescription to five years, where the Commissioner General of Inland Revenue (CGIR) is of the opinion that the profits and income of any person (includes a company) 'has not been ascertained having regard to the arm's-length price'.

In Sri Lanka, from the commencement of income tax dating back to 1932, there is in place a general provision in the income tax statute that could be invoked by the IRD should related parties not carry out transactions on arm's-length standard. The Assessor is authorised, if the Assessor considers any transaction reduces or has the effect of reducing the amount of tax payable to be artificial, to disregard such transaction and recompute profits and income to counteract any tax advantage derived by the taxpayer. This enabled the IRD to review related-party transactions and to assess the profits in relation to that transaction on the basis of arm's-length standard. Further, where the business arrangements entered into between a non-resident and a resident

are closely connected and the resident derives no profit or less profit than may be expected, the non-resident may be assessed for Sri Lanka tax, as if the non-resident was carrying on business in Sri Lanka through the resident as his agent. Thin capitalisation rules in place focused on providing a cap on the deductibility of interest payable on a borrowing by a thinly capitalised subsidiary to its holding company or to a subsidiary in the holding company's group.

The aforesaid provisions in the IRA were, apparently, considered inadequate by the Government to counteract dubious TP arrangements. Accordingly, Sections 104 and 104A were introduced to the IRA in order that profits and income or loss, as the case may be, 'be ascertained having regard to the arm's-length price'. These provisions are concise in content and were supplemented with the regulations prescribed in the Sri Lanka Gazette Extraordinary No. 1823/5 of 12 August 2013.

The Sri Lanka TP regulations are broadly in line with Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (OECD Guidelines). The IRD would seek guidance, where the current regulations are found inadequate, from the OECD Guidelines. However, the OECD Guidelines are not binding on the IRD.

The IRD Guidelines state, in relation to its guidelines, that they 'are largely based on the governing standard for transfer pricing which is the arm's-length principal as set out under (OECD) Transfer Pricing Guidelines'. It adds that 'although some parts of the Guidelines have been adopted directly from OECD Transfer Pricing Guidelines, there may be areas which differ to ensure adherence to the Inland Revenue Act No 10 of 2006 and the Inland Revenue Transfer Pricing Guidelines (i.e. the regulations) as well as domestic circumstances'. Broadly, in case of multinational companies carrying on business in Sri Lanka, insofar as they structure their TP strategies consistent with the OECD Guidelines that would be acceptable to the IRD.

Sri Lanka has, currently, a large double tax treaty network with the number of countries, with which double tax agreements (DTAs) have been entered into, exceeding 40.

Article 9 on Associated Enterprises in the DTAs is concerned with the issue of TP. It provides that the arm's-length principle be applied to commercial and financial relations between associated enterprises residing in the respective contracting states. In brief, Article 9(1) provides that profits made by one enterprise from dealings with another enterprise may be increased to the level they would have been, had the enterprises been independent and dealing at arm's length. Article 9(2) then provides for a corresponding adjustment if, as a result, the same profits would be taxable in both countries.

The arm's-length principle is affirmed by Article 7(2) of the DTAs for purpose of determining the taxable income of a permanent establishment. This clause contains a general directive, according to which '… where an enterprise of a contracting State carries on business in the other State through a permanent establishment situated therein, there shall in each contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities and under the same or similar conditions and dealing wholly or independently with the enterprise of which it is a permanent establishment'.

It is generally accepted that the treaty provisions would be applicable only in conjunction with statutory TP rules.

Sri Lanka

Legislation and Guidance

The IRA incorporates two provisions in relation to TP. Section 104 of the IRA relates to TP pertaining to international (cross border) transactions and 104A pertaining to domestic transactions between two associated undertakings. The two provisions are substantially identical, and the discussion that follows would focus primarily on TP in regard to international transactions.

Section 104 of the Act provides that any profits and income arising, derived or accruing from, or any loss incurred in, any international transaction entered into between two associated undertakings shall be determined having regard to arm's-length prices. The onus is placed on the taxpayer to satisfy that the profits and income or loss, as the case may be, has in fact been ascertained according to arm's-length pricing. Where it appears to the Assessor that the respective profits and income has not been ascertained having regard to the arm's-length price, the Assessor may refer the computation of the arm's-length price in relation to the 'international transaction' to a TPO. The TPO may, in writing to the person who carries on either one or other or both of the two undertakings, require the person to prove to the satisfaction of the TPO that such profits and income has, in fact, been ascertained according to arm's-length pricing, and when such person fails to so prove, the Assessor may, upon being informed by the TPO, estimate the amount of profits and income, or the loss, and make an assessment accordingly.

International Transaction

'International transaction' has been defined in the IRA to mean a transaction between two or more associated undertakings, where one or both of which are non-residents.

The term covers transactions in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money or any other transaction having a bearing on the profits and income, losses or assets of such undertaking, and further includes any allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such undertakings under any mutual agreement or arrangement between two or more such associated undertakings.

Any transaction entered into by an undertaking with a person, either one is non-resident, other than an associated undertaking, shall be deemed to be an international transaction entered into between two associated undertakings, if there exists a prior agreement between such undertaking and other person and, by which the terms of such transaction are determined in substance between such undertaking and other person, which results in the reduction of, or would have the effect of reducing, the amount of tax payable.

It is also provided that the allowance for any expense or interest arising from an international transaction be determined having regard to the arm's-length price.

Arm's-length price

Arm's length price is defined in the IRA to mean a price applied in uncontrolled conditions in a transaction between persons, other than associated undertakings.

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

The IRD endorses the arm's-length standard in accordance with OECD requirements i.e. intercompany (between associated undertakings) transactions should take place at values that are in accordance with industry standards and are commercially justifiable. The IRD Guidelines provide an explanatory Note on the concept of the arm's-length price.

Important factors that influence the arm's-length pricing would include the type of transactions under review as well as the economic circumstances surrounding the transaction. Accordingly, the arm's-length price, where an enterprise transfers goods or merchandise to a related enterprise, would be that price which unrelated parties would have agreed, under the conditions existing in commercially comparable markets for transfers:

- of similar goods or merchandise
- in comparable quantities
- to the same sales market
- at the same point in the chain or production and distribution, and
- with comparable terms for delivery and payment.

A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances. In order to be 'comparable' to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must only be sufficiently similar that it provides a reliable measure of an arm's-length result, i.e. none of the differences (if any) between situations being compared could materially affect the conditions being examined, e.g. price or margin. To meet the arm's-length standard, a controlled taxpayer's results need only be within the range of results determined by the results of two or more comparable uncontrolled transactions.

Associated Undertakings

An undertaking, which participates directly or indirectly or through one or more intermediaries in the control of another undertaking, in such manner or to such extent as may be prescribed would be deemed an associated undertaking,

The TP regulations prescribe two undertakings shall be deemed to be associated undertakings, if, at any time during the previous year:

- one enterprise holds, directly or indirectly, shares carrying not less than 50% of the voting power in other undertaking
- any person or enterprise holds, directly or indirectly, shares carrying not less than 50% of the voting power in each of such undertaking
- loans advanced by one undertaking to the other undertaking constitutes not less than 51% of the book value of the total assets of the other undertaking
- one undertaking guarantees not less 25% of the total borrowings of the other undertaking

- more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one undertaking are appointed by the other undertaking
- more than half of the board of directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two undertaking are appointed by the same person or persons
- the manufacture of processing of goods or articles or business carried out by one undertaking is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other undertaking is the owner or in respect of which the other undertaking has exclusive right
- 90% or more of the raw materials and consumables required for the manufacture or processing of goods or article carried out by one undertaking, are supplied by the other undertaking, or by persons specified by the other undertaking, and the prices and other conditions relating to the supply are influenced by such other undertaking
- where one undertaking is controlled by an individual or jointly by such individual and his relative, and the other undertaking is controlled by such individual or his relative or jointly by such individual and his relative or jointly by relatives of such individual
- where one undertaking is a firm, association of persons or body of individuals, the other undertaking holds not less than 10% interest in such firm, association of persons or body of individuals, or
- there exists between the two undertaking, any relationship of mutual interest, as may be prescribed.

Transfer pricing methodologies

TP methods to be used as analytical tools, designed to test the arm's-length character of transfer pricing results between related parties have been prescribed in the Sri Lanka Gazette Extraordinary No 1823/5 of 12 August 2013.

The prescribed methods are the following:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).

Comparable uncontrolled price method

Under the CUP method, the arm's-length price for the transfer of goods or services between related parties is determined by the price paid for the same or similar goods or services in a transaction between unrelated parties. This method, accordingly, sets the arm's-length price by reference to comparable transactions between a buyer and seller who is not associated undertakings. A comparison is made between the price charged for goods or services transferred in a controlled transaction to the price charged for goods or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated undertakings are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

Resale price method
RPM tests the arm's-length character of a transfer price in a controlled transaction by reference to the gross profit margin (i.e. gross profit divided by net sales) realised in a comparable uncontrolled transaction. The RPM starts with the price at which the related purchaser (the reseller) resells the goods to unrelated third parties and then deducting from such resale price:

- normal gross profit mark-up for the reseller (determined on the basis of mark-up percentages in fully uncontrolled purchase and resale transactions which are most similar),
- costs associated with the purchaser.

What is left after such deduction would be considered as the arm's-length price for the original seller of the goods.

Cost plus method
CPM tests the arm's-length character of a transfer price by reference to the profit mark-up on value-adding costs that is realised in a comparable uncontrolled transaction. Under this method, the arm's-length price which a related seller should charge a related buyer is the total cost plus an appropriate gross profit mark-up (expressed as a percentage of cost) determined on the basis of mark-up percentages in uncontrolled transactions which are most similar.

Profit split method
PSM is based on the concept that combined profits earned in a controlled transaction should be equally divided between associated undertakings involved in the transaction according to the functions performed. To arrive at an arm's-length price, the value of the contribution that each undertaking makes to the transaction is evaluated based on how uncontrolled undertakings would split profit among them under similar circumstances.

Transactional net margin method
This method tests the arm's-length character of transfer prices in a controlled transaction by comparing the operating profits earned by one of the parties engaged in controlled transactions to the operating profits earned by uncontrolled parties engaged in similar business activities under similar circumstances.

The measure of an arm's-length result, under this method, is the amount of operating profit that one party to the controlled transaction would have earned in relation to an appropriate base, e.g. turnover or costs, had its level of profitability been equal to the profitability of a comparable uncontrolled party.

Selection of the most appropriate method
The TP regulations require the taxpayer to select the method which is best suited to the facts and circumstances of each particular transaction and which provides the most reliable measure of an arm's-length price in relation to the transaction. In determining the reliability of a method, the two most important factors to be taken into account are:

- The degree of comparability between the controlled and uncontrolled transactions.
- Completeness and accuracy of the available data.

The regulations prescribe that, in selecting the most appropriate method, the following factors should be taken into account:

- Nature and class of the transaction.
- Class or classes of associated undertakings entering into the transaction and the functions performed by them taking into account the assets employed or to be employed and risks assumed by such undertakings.
- Availability, coverage and reliability of the data necessary for application of the method.
- Degree of comparability existing between the transaction and the uncontrolled transaction and between the undertakings entering into such transactions.
- Extent to which reliable and accurate adjustments can be made to account for differences, if any, between the transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions.
- Nature, extent and reliability of assumptions required to be made in the application of a method.

Threshold on applicability of transfer pricing regulations

The TP regulations published in the Gazette Extraordinary No 1823/5 of 12 August 2013, apply only in cases where the aggregate value, as recorded in the books of account in a given tax year, of transactions between the taxpayer and the associated undertaking(s) exceed 100 million in case of international transactions and 50 million Sri Lankan rupees (LKR) in case of domestic transactions.

Advance pricing agreements

Transfer pricing regulations provide for a taxpayer to enter into an advance pricing agreement (APA) with the IRD for a particular transaction or for a series of transactions that have been set at arm's-length standards. However, the procedures for applying for and agreeing to APAs have still not been laid down. The documentation, based on which the transfer price was set, needs to be furnished with an application for an APA.

Auditor certification

CGIR published a Gazette Extraordinary No 1907/26 of 25 March 2015 directing that the taxpayer file, as part of the tax return under Section 107 of the IRA certificate from the auditor listing the associated undertakings with which the taxpayer has entered into transactions, together with details of the respective transactions and certifying the TP method used by the taxpayer used to determine the arm's-length price in relation to such transactions.

The auditor is required to confirm that he examined the accounts and records of the taxpayer relating to the transactions entered into with associated undertakings during the relevant tax year, and express an opinion on which proper documentation, as prescribed, has been kept regarding transactions that the taxpayer has entered into with associated undertakings, as appears from the auditor's examination of the records of the taxpayer.

This certificate would be critical as it would form the stepping stone for the IRD to conduct a transfer pricing audit.

Director's certificate

Directors of a company are required to file a certificate as part of the director's report in the published financial statements that all transactions entered into with associated undertakings are carried out on an arm's-length basis.

The director's report is required to confirm the following disclosures relating to TP:

- Record of transactions entered into with associated undertaking.
- TP policy statement describing the strategies and policies influencing the determination of transfer price.
- Management perception of risk factors involved, if any.
- Amounts or appropriate proportions of outstanding items pertaining to related-party balances and provisions for doubtful debts due from such parties as on balance sheet date.
- Any other material information pertaining to related-party transactions that are necessary for understanding of the financial statements or are required to be disclosed under any other law or under any accounting standard.

Intangible property

Currently, payments by local users to non-resident beneficial owners of familiar intangibles for the right to use patents, trademarks, trade names, designs or models, literary and artistic property rights, know-how and trade secrets are reviewed by the IRD by reference to Article 12 of the DTAs in force between Sri Lanka and its tax treaty partners. Article 12(6) provides a specific test check on the possible abuse of the pricing of the payments that can occur as a result of a special relationship between the local payer and the non-resident payee. The adjustment, prescribed, is to assess in the hands of the non-resident, in terms of the IRA, what can be identified as the excess part of the payment.

TP methodologies prescribed in the regulations have not so far been harnessed in this area of cross-border taxation. However, the IRD Guidelines include a chapter describing parties entitled to intangible related returns, payment for transfer of intangible property, marketing intangibles, application of the arm's-length principle, TP methodologies for intangible property etc.

These Guidelines set forth the following:

"The CUP method can be used in benchmarking transactions involving intangible properties. When difficulties arise in identifying reliable comparables due to the uniqueness of the intangible, the profit split method or any other methods that can provide the highest degree of comparability can be applied where both parties to the transaction own highly valuable intangibles.

In determining the arm's-length consideration for transfer of intangibles, an undertaking who is the licencee or the buyer of the intangible property may consider the following:

- Perform a functional analysis which covers:
  - the type of intangible involved
  - the value of the intangible
  - the opinion of industry experts on the value of the intangible, if necessary, and
  - the duration that the intangible is expected to maintain its value.

- Determine the rate of return that is commensurate with the amount of royalty paid by performing a financial analysis.
- Ensure that the amount of consideration paid make economic sense and the undertaking is better off with utilising an associated undertaking's intangible property."

Intragroup services

In applying the arm's-length principle to intragroup services, the IRD Guidelines specify that it is necessary to consider from the perspective of both the provider and the recipient of the service. The service must be of value to the recipient and the price must be one that an independent party would be prepared to pay. In determining arm's-length prices for intragroup services, the service recipient may apply CUP together with a benefit test. For the service provider, both, the CUP and the CPM method may be applied.

In determining the arm's-length price charged for an intragroup service, the following factors should be taken into consideration:

- Nature of the service.
- Value/extent of the benefit of the service to the recipient.
- Costs incurred by the service provider in providing the service.
- Functions involved in providing the service.
- Amount an independent recipient would be prepared to pay for that service in comparable circumstances.
- Other options realistically available to the recipients.

Intragroup financing

The IRD Guidelines set out the following observations in regard to intragroup financing.

An arm's length interest rate is an interest rate charged, or would have been charged, at the time the financial assistance was granted in uncontrolled transactions with or between independent undertakings.

In determining an arm's-length interest rate for financial assistance, the CUP method is considered to provide the most reliable measure. In this context, the CUP method determines an arm's-length interest rate by reference to interest rates between independent parties on loans with highly similar terms and conditions. Where differences exist, adjustments should be made to eliminate these differences.

Comparability factors to consider when searching for and analysing financial transactions and the determination of arm's-length interest rate include:

- Nature and purpose of the financial assistance.
- Amount, duration and terms of the financial assistance.
- The type of interest rate (e.g. fixed or floating interest rate).
- Embedded options.
- Guarantees involved in the financial assistance.
- Collateral for the financial assistance.
- Creditworthiness of the borrower.
- Location of the lender and borrower.

When ascertaining the arm's-length interest rate, appropriate indices such as Inter Bank Offered Rate (LIBOR), prime rates offered by banks and/or specific rates quoted by banks for comparable loans can be used as a reference point. Adjustments are then made on the rates used as reference point based on the outcome of comparability analysis to arrive at the arm's-length interest rate.

Documentation

Retention of record

Taxpayers are required to keep sufficient records for a period of five years from the end of the tax year to which income from the business relates. All records relating to any business in Sri Lanka must be kept and retained in Sri Lanka. Records under TP regulations include books of accounts, invoices, vouchers, receipts and other documents necessary to verify entries in any books of accounts.

For TP purposes, a taxpayer who has entered into a transaction with an associated undertaking in the basis year for a tax year is required to not only maintain the above records, but also prepare and keep contemporaneous documentation to assist in demonstrating that the taxpayer's TP policy is appropriate for tax purposes.

Contemporaneous transfer pricing documentation

Documentation is deemed 'contemporaneous' if it is prepared:

- at the point when the taxpayer is developing or implementing any arrangement or TP policy with its associated undertaking, and
- if there are material changes, when reviewing these arrangements prior to, or at the time of, preparing the relevant tax return of his income for the basis year for a given tax year.

Submission of transfer pricing documentation

TP documentation is not required to be filed with the annual tax return. However, the documentation is required to be made available to the IRD within 30 days upon request.

List of documentation

Every associated undertaking who entered into an international transaction should keep and maintain in Sri Lanka (in English) the following information and documents:

- A description of the ownership structure of the taxpayer undertaking with details of shares or other ownership interest held therein by other undertaking.
- A profile of the multinational or group of which the taxpayer undertaking is a part, along with the name, address, legal status and country of tax residence of which of the undertakings comprised in the multinational or group with whom transactions have been entered into by the taxpayer, and ownership linkages among them.
- A broad description of the business of the taxpayer and the industry in which the taxpayer operates, and of the business of the associated undertakings with whom the taxpayer has transacted.
- The nature and terms (including prices) of international or group transactions entered into with each associated undertaking, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction.

- A description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated undertaking involved in the transaction.
- A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the taxpayer for the business as a whole and for each division or product separately, which may have a bearing on the transactions entered into by the taxpayer.
- A record of uncontrolled transactions taken into account for analysing their comparability with the transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the transactions.
- A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant transaction.
- A description of the methods considered for determining the arm's-length price in relation to each transaction or class or transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case.
- A record of the actual working carried out for the determining the arm's-length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the transaction and the comparable uncontrolled transactions, or between the undertakings entering into such transactions.
- The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's-length price.
- Details of the adjustments, if any, made to transfer prices to align them with arm's-length prices determined under these regulations and consequent adjustment made to the total income for tax purposes.
- Any other information, data or document, including information or data relating to the associated undertaking, which may be relevant for determination of the arm's-length price.

The information furnished in respect of TP should be supported by authentic documents, which may include the following:

- Official publications, reports, studies and data bases from the Government of the country of residence of the associated undertaking, or of any other country.
- Reports of market research studies carried out and technical publications brought out by institutions of national or international repute.
- Price publications including stock exchange and commodity market quotations.
- Published accounts and financial statements relating to the business affairs of the associated undertaking.
- Agreements and contracts entered into with associated undertaking or with unrelated enterprises in respect of transactions similar to that transaction.
- Letters and other correspondence documenting any terms negotiated between the taxpayer and the associated undertaking.
- Documents normally issued in connection with various transactions under the accounting practices followed.

Penalties

There are no specific penalties prescribed for non-compliance with the TP statutory provisions. The general penalty provisions will apply to assessments raised on account of TP adjustments. The monetary penalty is twice the underpaid tax plus LKR 2,000. This is in addition to the penalty on late payment of tax, which is 10% of the tax for first month of default and 2% of the tax for each succeeding month of default up to a maximum of 50%.

Transfer pricing dispute resolution

Where a taxpayer is dissatisfied by an assessment raised on account of a transfer pricing dispute, the taxpayer could invoke the normal appellate procedure laid down in the IRA.

The appellate procedure takes the following form:

- Letter of appeal, stating precisely the grounds of appeal, which should be filed within 30 days of the notice of assessment, addressed to the CGIR.
- CGIR may cause, on receipt of the appeal, an inquiry to be made by an Assessor (other than the Assessor who made the assessment) on the matter under appeal.
- If a settlement is reached at the Assessor's stage, the assessment may be revised accordingly.
- Where no agreement is reached between the appellant and the Assessor, CGIR or a senior tax officer designated by him, will hear the appeal.
- CGIR may confirm, reduce, increase or annul the assessment and give notice to the appellant of his determination.
- If the appellant is dissatisfied with the determination of the CGIR, the appellant may appeal to the Tax Appeals Commission (TAC).
- TAC will hear the appeal and make its determination.
- Where the appellant is dissatisfied with the determination of the TAC, the appellant could require the TAC to state a case for the opinion of the Appeal Court.
- Court of appeal will hear and determine the question of law arising on the stated tax and may confirm, reduce, increase or annul the assessment determined by the TAC.
- Any party dissatisfied with the decision of the Court of Appeal may take up an appeal before the Supreme Court, on a substantial question of law.

In most tax cases in Sri Lanka, the issues are negotiated and resolved at the Assessor's stage. No case involving TP has yet been taken up before the law courts.

Comparison with the OECD Guidelines

Sri Lanka's TP legislation follows substantially the OECD principles. The arm's-length pricing methodologies and tests of control have largely been adopted from the OECD Guidelines. In the final analysis, in case of TP, the IRD will, though not binding, seek guidance and follow the OECD Guidelines.

Sri Lanka

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Sweden

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Overview

In Sweden transfer pricing (TP) continues to be an area of focus for the Swedish Tax Agency (STA), overall TP issues are given a high priority in the STA's audit procedures. As such, the audit of TP-related issues, in which restructurings have had a pronounced role, has intensified.

Moreover, recent legal cases have shown that the much debated court case ruling (Diligentia-case), in regard to intragroup loans, is no longer valid as more recent decisions issued by the administrative courts of appeal has shown that ownership does not automatically entail a degree of insight or control. As such, each transaction should be assessed on its own merits and circumstances, in which the contractual conditions are of importance when determining whether an intragroup loan is at arm's length.

Country	**Sweden**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Upon request
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Not applicable
How are penalties calculated?	Not applicable

Sweden

Introduction

On 1 January 2007, the Swedish legislation dealing with TP was extended substantially. The statutory rule of the Swedish Income Tax Act (SITA), adopting the arm's-length principle for transactions between related enterprises was supplemented by formal documentation requirements. Parallel to this legal framework, two cases did during the 1990s, establish important principles for dealing with TP issues. These principles concern, in particular, the areas of thin capitalisation and the circumstances in which TP adjustments may be made.

It is worth noting that, in general, the STA is very interested in TP, using the regular tax audit as an opportunity to investigate TP issues. During the last few years, the STA has shown an increased focus on TP-related issues through a number of detailed questions in tax audits including questions about what comparable transactions or companies have been used as a basis for determining the transfer prices. Furthermore, a number of new cases show an increased focus on TP. A highly skilled, specialised team has also been established within the STA to continuously develop the general awareness within the TP area.

Legislation and guidance

Sweden has only one statutory rule on TP. Originally included in the tax code in 1929, it is now found in Chapter 14 section 19 SITA. This section adopts the arm's-length principle for transactions between related enterprises and authorises an increase in the taxable income of a Swedish enterprise, equal to the reduction of income resulting from transactions that are not at arm's length.

Besides the arm's-length rule, Chapter 19 section 2b of Law 2001:1227 introduced documentation requirements for all corporations registered in Sweden, which conduct cross-border controlled transactions. It is now compulsory to prepare written documentation on all cross-border transactions with associated companies. The statutory addendum came into effect as of 1 January 2007.

As of 1 January 2010, the Law (2009:1295) on Advance Pricing Agreements regarding international transactions (Law on APAs) entered into force in Sweden. The Swedish legislation describes an advance pricing agreement (APA) as a contract between a taxpayer and the STA, in two or more countries, specifying the TP policy and the TP methodologies that a taxpayer may use on its intragroup cross-border transactions. The STA is the competent authority for the administration of the APAs.

In connection with the documentation requirement, administrative guidelines (SKVFS 2007:1) were issued by the STA on 14 February 2007. Moreover, the STA published regulations that provide further details as well as examples related to the TP documentation requirements. Guidelines and regulations are applicable retroactively as of 1 January 2007 and are further commented on below. Generally, the documentation requirements cannot be considered to be materially more demanding for the taxpayers from an international comparison perspective.

During the last few years, relatively few TP cases have reached the lower courts and the Court of Appeal. However, there have been two important cases from the Supreme Administrative Court, which should be noted. The first, Mobil Oil (1990), concerned thin capitalisation and the second, Shell Oil (1991), concerned the pricing of crude oil and freight. The tax authorities lost both cases.

The principle established by the Mobil Oil case is that, generally, thin capitalisation cannot be challenged in Sweden using the arm's-length rule.

The Shell case clearly demonstrates three points. First, the STA bears the full burden of proof in TP matters. Second, consideration of whether an arm's-length price has been charged should not be restricted to the facts arising in a single year, but rather, a span of years should be considered. Third, if a TP adjustment is to be justified, there must be a deviation from arm's-length pricing, which is significant in size. Moreover, the Shell case was the first case in which the courts referred to the principles laid down in the Organisation for Economic Co-operation and Development (OECD) Guidelines on TP.

In Sweden, a much debated court case ruling (Diligentia-case) was released from the Supreme Administrative Court during 2010. The case involved a Swedish taxpayer who chose to replace an external loan with a loan from a Swedish-related party to a higher interest rate, claiming that the loan was unsecured although the company's assets were unclaimed as no external loans existed. The STA argued that the intragroup loan was in fact secured and consequently the interest rate exceeded what could be deemed to be a market rate. The Swedish Supreme Administrative Court's verdict was in line with the STA's argumentation. The verdict stated that the insight and control of a shareholder can have an impact on the interest rate of a related-party loan, but this must be evaluated on a case-by-case basis. It should be noted that the verdict is based on paragraph 16.1 of the SITA, since the transaction took place between two Swedish entities and not 14.19 in the SITA, which regulates cross-border transactions. Therefore, its application in a cross-border situation is uncertain.

Following the Supreme Administrative Court's verdict the STA decided to adopt the approach that all intragroup loans, more or less regardless of facts and circumstances in cross-border cases, should only be deemed comparable with secured loans since, in their view, ownership automatically equals a degree of insight and control that replaces the need for security, even in cases where external loans with better rights to the underlying assets, exist.

Currently, there are many cases pending, related to this issue and in 2011 the Lower Administrative (tax) Courts issued six verdicts in which this principle was applied to cross-border transactions. The STA arguments are contradictory to the arm's-length principle and economic theory, wherefore it is believed that intragroup loans should still be priced in accordance with comparable external loans, i.e. no particular concern should be taken for insight and control by comparing unsecured loans with secured external loans. If at all to be considered, in PwC's opinion the same type of insight and control that can be argued to exist in shareholder loans is comparable with the insight and control required by lenders for most loans.

However, these verdicts were appealed and more recent decisions issued by the administrative courts of appeal, have shown that ownership does not automatically entail a degree of insight or control. As such, each transaction should be assessed on its own merits and circumstances, in which the contractual conditions are of importance when determining whether an intragroup loan is at arm's length.

Other cases concerning, for instance, support services, usually provided from the parent company for the benefit of subsidiaries, have also been dealt with by Swedish courts. This large number of cases – by Swedish standards – in a short period of time further illustrates that the STA have acquired additional resources and have increased their focus on TP issues.

A principle established by the Mobil Oil case is that the arm's-length principle cannot be used to challenge a taxpayer on the grounds of thin capitalisation. Furthermore, there are no rules dealing specifically with thin capitalisation and no set permissible debt-to-equity ratios. Interest paid to a foreign associated entity is deductible for tax purposes without any restrictions as long as arm's-length interest rates are applied. However, in special situations with unique circumstances, interest deductions may be challenged, even if the tax authorities have not yet successfully challenged any instances of thin capitalisation, and taxpayers should remain cautious in this area.

Penalties
Penalties are normally levied at a rate of 40% of the additional tax due. Penalties paid are not tax-deductible. There is no separate penalty charge for non-compliance with the TP documentation requirements.

The tax penalty may constitute what qualifies as a 'serious penalty', which would prevent the application of the Arbitration Convention. However, this has never been the case practice.

Documentation
According to the documentation requirements in force since 1 January 2007, TP documentation has to provide the following information:

- General description of the company, the organisation and its activities.
- Information about the nature and extent of the transactions.
- Functional analysis.
- Description of the TP method chosen.
- Benchmark analysis.

Companies entering into transactions of limited value can benefit from simplified documentation requirements. Transactions of limited value are defined as intragroup transactions of goods for a value of less than approximately 27.7 million Swedish kronor (SEK) per company within a multinational enterprise (MNE), and for other transactions, a value of less than approximately SEK 5.5 million. The concept of other transactions does not include the transfer of an intangible asset. If a transfer of intangible property occurs, no simplified documentation requirement applies.

The simplified documentation requirement stipulates that the following information should be provided in a summary or schematic form as described in the following:

- Legal structure of the group.
- Organisation and operations of the tested party.
- A short description of the counterparties to the transactions including their main activities.
- Actual transactions – nature, extent, value – together with the TP method applied.
- How the arm's-length principle is met.
- Comparable transactions, if appropriate and if any are identified.

The EU Code of Conduct and the EU transfer pricing documentation (TPD) are explicitly accepted in Swedish legislation. Transfer pricing documentation may be submitted in Swedish, Danish, Norwegian or English languages.

Transfer pricing controversy and dispute resolution

Related-party transactions within all industries can be subject to audit. The most common issues scrutinised by the STA regarding intragroup transactions relate to financial transactions (such as interest rates) and business restructuring including particularly, valuations and transfers of intangible property. Particular focus is also directed at sizeable MNEs reporting low or negative operating margins.

Following the implementation of documentation requirements, audit procedures commonly include scrutiny of the complete TP documentation including all transactions and benchmarks applied. In this context, it can be noted that it is becoming more and more common that the STA performs benchmarks by means of in-house resources.

The 250 largest Swedish multinational groups are, on average, audited every five years. A few hundred foreign-owned companies are audited more regularly. In recent years, the STA has taken a more risk-based approach. This means that the STA is more likely to audit high-risk companies from a tax-avoidance perspective. Whether a company is classified as high risk is based on a scorecard system. Transfer pricing is currently given a high priority in Sweden, and the audits provide an opportunity for the authorities to focus on the companies' TP policies, which has in many cases led to further scrutiny by the STA. As such, the audit of TP-related issues, in which restructurings have had a pronounced role, has intensified.

During the course of the audit, the STA may examine all intragroup transactions. The audits are always conducted at the company premises, with key personnel being interviewed. The conduct of the taxpayer during the examination is likely to affect the outcome of the audit, and the early assistance of a competent tax adviser is therefore highly recommended. Where the STA believes that the arm's-length standard has not been applied, it may be possible to achieve a negotiated settlement.

The STA may request copies of any information that is kept on the premises of the taxpayer, and it has the authority to search the premises, where deemed necessary.

The STA bears the full burden of proof when trying to establish that a TP adjustment is necessary. To support the adjustment, the STA must show that:

- the party to whom the income is transferred is not liable to taxation in Sweden on that income
- they have reasons for believing that a community of economic interests exists between the contracting parties
- it is clear from the circumstances that the contractual conditions have not been agreed upon for reasons other than economic community of interest
- the adjustment does not depend upon consideration of the facts applying to one year in isolation, and
- there has been a significant deviation from the arm's-length price, sufficient to justify an adjustment.

An appeals' procedure is available to the taxpayer, but it is a time-consuming process. The procedure for tax cases handled by the administrative courts and the Administrative Court of Appeal both normally require two to three years each.

The resources available for the STA to conduct TP audits have historically been limited. Today, a specialised TP team is established in the STA, which is continuously recruiting more inspectors and acquiring new competence within the TP area. The effect of this team is clearly illustrated by the increased number of cases brought before the courts. This specialised team assists the general tax auditors in the STA with TP issues as well as performing its own targeted audits towards large companies.

The STA has taken part in simultaneous tax audits from time to time and sometimes cooperates with other Nordic countries in such audits. Also, the STA has taken part in a few simultaneous audits with the US and German tax authorities, respectively.

Swedish law, currently, has no regulation that automatically relieves a company from juridical and/or economic double taxation, caused by an adjustment of its transfer prices. The problem of double taxation is, instead, usually handled through bilateral tax treaties. Swedish tax treaties are usually based on the OECD Model Tax Convention. Some older agreements existing between Sweden and developing countries are based on the UN Model Tax Convention.

Sweden has entered into bilateral tax treaties with the majority of countries in which Swedish-based MNEs conduct business. These agreements provide a good basis for the elimination of juridical and/or economic double taxation for both Swedish multinationals and foreign multinational companies conducting business in Sweden.

The competent authority procedure functions fairly well in Sweden. According to the Ministry of Finance, full or partial relief has historically been obtained in more than 90% of cases where competent authority relief has been claimed. The competent authority's responsibility and the mutual agreement procedures (MAPs) were recently transferred to the STA. However, one problem with competent authority claims is the amount of time necessary to settle each case. After the transfer of responsibility for the MAPs to the STA, the effectiveness of these procedures has increased considerably. Delays in current processes are often the result of delays in other countries. The normal handling period for the competent authority procedures is about two years.

Sweden has signed the EU Arbitration Convention, which applies from 1 November 2004. The EU Arbitration Convention constitutes a powerful incentive for the STA to make every effort to ensure that the administrative process is more efficient, and a means to ensure that a mutual agreement is reached within the fixed time limit of two years.

As of 1 January 2010, the (2009:1295) law on APAs entered into force in Sweden. The STA was appointed as competent authority for the administration of APAs.

Under the law on APAs, any corporation that is (or is expected to become) liable to taxation, in accordance with Swedish taxation regulations, and which is subject to the provisions of a tax treaty, can apply for an APA. The application shall be made in writing and shall contain all information deemed necessary to enable the STA to make a fair decision as to the appropriateness of the taxpayer's suggested TP set-up. Prior to filing an application, the taxpayer may request a pre-filing meeting with the STA to

discuss the conditions of a potential APA and what information should be included in the application.

A Swedish taxpayer can apply for either a bilateral or a multilateral APA. The APA is based on a mutual understanding between the countries involved for a predetermined period of three to five years.

The STA is authorised to grant an APA if the relevant transaction can be regarded separately from any other intragroup transactions, and if sufficient information is provided to the STA to enable it to determine whether the proposed set-up is at arm's length. Some of the basic information which must be filed in order for the STA to grant an APA is a functional analysis, an economic analysis and a comparables' search, which supports the selection of TP methodology.

An APA is granted only if the mutual understanding between the countries involved reflects the basis of the taxpayer's application or if the taxpayer approves any amendments proposed in the STA's decision. An APA is normally not granted if the transaction is considered to be of limited importance or of minor value.

In cases where a taxpayer seeks an APA, the STA charges an administration fee, which is based on the type of application. The following fees apply in relation to each country involved in the relevant transaction:

- SEK 150,000 (approx. 17,000 euros [EUR]) for an application of a new APA.
- SEK 100,000 (approx. EUR 11,000) for an application regarding renewal of a previous APA.
- SEK 125,000 (approx. EUR 143,000) for an application regarding renewal of a previous APA (including amendments).

Comparison with OECD Guidelines

Sweden is an OECD Member State. There was a Swedish representative on the OECD Transfer Pricing Task Force, and Sweden has agreed to the OECD Guidelines.

In accordance with the OECD Guidelines, the determination of an arm's-length price has to be based upon prices that would be agreed between unrelated parties in a comparable situation. In determining the relevant price, the STA prefers the traditional transactional methods, but with no preferred order of use. If none of these methods can be used, then a transactional profit method may be used. The STA considers the transactional net margin method (TNMM) to be the most frequently used method to test the arm's-length character of transfer prices in practice. The TNMM approach is also used to test another method (i.e. a secondary method for sanity check purposes).

The financial statements of all Swedish companies are publicly available in Sweden. Databases containing this information may be accessed in the search for comparables. The STA has also gained access to the most common databases used for comparability searches, such as the European database AMADEUS and various royalty databases. In recent tax audits, the STA has prepared extensive lists of questions regarding the audited company's comparable data.

Sweden

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Switzerland

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Overview

Switzerland does not have specific transfer pricing (TP) regulations but adheres to the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. To clarify TP issues and ensure certainty on a company's future TP policy, Switzerland offers an informal procedure for agreeing pricing policies in advance.

Swiss tax authorities, however, are becoming increasingly concerned that taxpayers may transfer profits without economic justification to countries with strict TP rules and documentation requirements in order to avoid challenges by the respective local tax authorities. In this context, Swiss tax authorities take an increasing interest in a company's TP position.

The TP landscape of Switzerland is also dependent on the updated or added guidance published by the OECD as a result of the base erosion and profit shifting (BEPS) action plan. It can be anticipated that the changes due to the BEPS project will also have an appropriate impact on the TP environment and practices in Switzerland.

Country	**Switzerland**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	If requested in a tax audit
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No

Switzerland

Country	Switzerland
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As percentage of lost tax revenue

Introduction

Switzerland does not have specific TP regulations but adheres to the OECD TP Guidelines. As far as is predictable, Switzerland has also no plans to issue any domestic provisions on TP in the near future. Swiss tax authorities, however, are becoming increasingly concerned that taxpayers may transfer profits without economic justification to countries with strict TP rules and documentation requirements in order to avoid challenges by the respective local tax authorities. In this context, Swiss tax authorities take an increasing interest in a company's TP position. To clarify TP issues and ensure certainty on a company's future TP policy, Switzerland offers an informal procedure for agreeing pricing policies in advance.

Legislation and guidance

Statutory rules

While Swiss tax law neither contains an explicit definition of the arm's-length principle, nor specifically addresses the issue of TP between related parties, there is some legal authority for adjusting the profits of a taxpayer on an arm's-length basis. This legal authority is found in Article 58 of the Federal Direct Tax Act as well as in Article 24 of the Harmonisation of the Cantonal Tax Laws Act, which both define the calculation of a taxpayer's taxable net profit. Importantly, Articles 58 and 24 deny a tax deduction for expenditure that is not commercially justifiable, and this provides the basis for an adjustment to profits for non-arm's-length terms.

Since the Swiss tax authorities believe that TP issues cannot be resolved through the provisions of domestic legislation, no significant changes to the existing statutory rules are expected. Indeed, the Swiss approach to TP issues is to follow the OECD TP Guidelines as closely as possible.

Swiss tax authorities have experienced and educated tax officers regarding TP issues and the use of the options for tax adjustments granted under existing Swiss tax legislation. This may have particular implications on costs related to the provision of services, licence fees and costs for tangible goods charged to Swiss companies, since the burden of proof in justifying the deductibility of expenses lies with the Swiss taxpayer.

We also perceive that tax authorities in certain cantons are increasingly insisting on an arm's-length remuneration for assumed intellectual property transferred in connection with a transfer of business opportunities.

In the wider Swiss corporate tax environment, it should be mentioned that a reform of the corporate tax system is now under way in Switzerland (Corporate Tax Reform III). Mainly due to BEPS developments and pressure from the European Union Switzerland is expected to abolish its cantonal tax regimes for holding and administrative companies. As part of the corporate tax reform, there is a high certainty that the still existing tax regimes will be replaced with an intangible property (IP) box regime that will reduce the effective corporate income tax rate of an ordinary taxed company, based on a preferential tax treatment of income, generated from licence income and IP-related products.

Services

Other regulations deal with the requirement for Swiss subsidiaries and permanent establishments (PEs) of foreign companies to include a profit mark-up when recharging the cost of performing services to a foreign-related company. No mark-up is required, however, where there is evidence that the marked-up price would be substantially different from the price that would have been paid in a comparable uncontrolled situation. In addition, an instruction issued in Circular Letter No. 4 on 19 March 2004 provides guidance on the treatment of certain services that do not require a cost plus (CP) methodology (e.g. certain financial services and general management services) and encourages a review of the methods and margins (or prices) charged for rendering such services when evaluating whether such charges were made on an arm's-length basis. Although a cost plus 5%–10% should in most instances meet the arm's-length comparison, a benchmark study is recommended to determine the exact rate.

Note that, since the cantonal authorities are not bound by the instructions of the Federal Tax Administration (FTA) when assessing taxes, there is some room for differences in approach between cantons. Therefore, it is possible that the cantonal authorities may adopt different methods of calculating the base of costs to be marked-up.

The charging for management services by Swiss service companies and PEs is subject to instructions from the FTA. Specific guidelines regulate the costs to be recharged and the method of calculating an appropriate profit element. Generally, a CP approach is deemed appropriate.

Interest payments

Switzerland maintains regulations concerning permitted tax-deductible interest rates on loans. The FTA regularly issues instructions on the safe harbour maximum and minimum interest rates as set by reference to the prevailing interest rates in the Swiss market. If a loan is in a foreign currency, the relevant market interest rates apply, which is, effectively, an application of the arm's-length principle. In practice, there is an interdependence of permissible interest rates and the permissible amount of debt in the context of thin capitalisation. If companies deviate from the safe harbour rates, it is strongly advised that they maintain documentation to support the arm's-length nature of the rates applied, as there have been an increasing number of audits in this area.

Thin capitalisation

As previously noted, the FTA frequently issues instructions in connection with minimum and maximum permissible interest rates. If interest rates charged are not within the specified range, then the rate may be adjusted. In conjunction with this practice, specific legislation indicates the permissible debt-to-equity (D/E) ratios. At the federal level, an instruction was released in June 1997 according to which the D/E ratio must be determined, based on the fair market value of a company's assets. The FTA believes that the amount of available borrowings should be determined, depending on the category of assets (receivables, participations, loans, property, installations, machinery, intangibles). Regarding finance companies, the safe harbour ratio is 6:1. The same rules apply to cantonal tax law based on Article 29 (a) of the Act on Harmonization of Cantonal Tax Laws.

Some flexibility is available in the application of these rules, particularly where they interact with the instructions on permissible interest rates. Thereby, where the combination of a modest interest rate with excessive indebtedness results in an interest charge that is arm's length, given the amount of debt that would normally be permissible, it is unlikely that any adjustment would be made to the actual interest paid. Obviously, an excessive interest rate on a high amount of debt would not be acceptable.

Penalties

Penalties apply where an adjustment is required as a result of a TP investigation in connection with a criminal proceeding (e.g. in the case of tax fraud). These penalties are not tax-deductible. The level of penalties imposed depends on the extent to which the taxpayer has defaulted and can be set as a multiple of between one and three times the additional tax revenue. No penalties apply on TP adjustments during a normal tax assessment.

Further, for Swiss withholding tax (WHT) purposes, any TP adjustment and the repayments or the issuance of credit notes by the Swiss company due to adjustments made by foreign tax jurisdictions and to the extent not agreed in a mutual agreement procedure are considered as deemed dividend distributions and are therefore subject to 35% Swiss WHT or grossed-up to 54% if the Swiss WHT charge itself is not borne by the beneficiary. However, such Swiss WHT might be partially credited or refunded, based on a potential double tax treaty (DTT) between Switzerland and the corresponding foreign tax jurisdiction.

Documentation

No documentation is required at the time of a transaction or at the filing of the tax return. The documentation might be required only upon request. The taxpayer does not have to prepare the documentation in advance of the audit.

However, it is recommended that taxpayers maintain appropriate documentation to justify all income and expenses resulting from related-party transactions.

Based on the latest publication (March 2015) Switzerland is committed to follow the OECD recommendations regarding TP documentation. Switzerland will introduce a legal basis in order to oblige the multinational groups concerned to prepare country-by-country reporting.

Transfer pricing controversy and dispute resolution

Burden of proof

The burden of proof within Switzerland lies with:

- the taxpayer, regarding the justification of tax-deductible expenses, and
- the tax authorities, regarding adjustments that increase taxable income.

This effectively means that a taxpayer has to prove to the Swiss tax authorities that the price it has paid for its tangibles, intangibles and any services it has received from a related party satisfies the arm's-length principle (i.e. justifies their tax deductibility). On the other side, the Swiss tax authorities' responsibility is to prove that the compensation for any services rendered by the taxpayer or any tangibles or intangibles transferred to a related party does not reach an arm's-length level. However, if a taxpayer fails to produce the documents required by the tax authorities, this burden of proof also reverts to the taxpayer. Therefore, Swiss taxpayers should maintain appropriate documentation to justify all income and expenses resulting from related-party transactions.

Legal cases

Several cases on TP have been brought before the Swiss courts, especially concerning the interpretation of costs that are not commercially justifiable (e.g. non-arm's-length transactions of management services, licence fees or excessive interest rates on loans made by a shareholder to a company), the use of company assets by the shareholder on privileged terms, and the restructuring of sister companies by means of non-arm's-length transactions.

Advance pricing agreements (APAs)

No formal procedure for agreeing pricing policies in advance with the tax authorities exists in Switzerland. The APA procedure is therefore informal in its nature. APAs are available to all industries (unilateral and bilateral).

Limitation of double taxation and competent authority proceedings

Switzerland's competent authority under the tax treaties is the State Secretariat for International Financial Matters (SIF) and the competent authority process is well established. Once a decision is final under Swiss law, competent authority procedures are the only means for a taxpayer to avoid double taxation.

Joint investigations

The Swiss authorities do not join with the tax authorities of another country to participate in a joint investigation. However, in case the tax treaty allows an exchange of information, Swiss tax authorities are obliged to share certain and specific information (i.e. with jurisdictions where a tax treaty is in place, which contains similar or the same regulations of article 26 of the OECD Model Tax Convention). In 2014, the Swiss Government announced that it will now systematically introduce the unrestricted article 26 in all its DTTs.

Tax audit procedures

In general, the attitude of the Swiss tax authorities towards TP in the course of tax audits has become more aggressive, especially when non-Swiss-headquartered companies are in a loss position in Switzerland. Companies can be selected for investigation if relevant profit-level indicators (e.g. gross margin, net margin or return on capital or applied licence rates) differ significantly from what is considered reasonable, or if the company is thinly capitalised.

The tax authorities may request any information that is relevant for properly assessing a company's profits. If the taxpayer does not comply, fines may be imposed and the burden of proof moves from the tax authorities to the taxpayer.

The normal tax audit procedures are performed by the cantonal tax authorities in respect of cantonal and federal taxes. It is normal in Switzerland for the outcome of such an investigation to be decided as a result of negotiation, but if no agreement can be reached, an adjustment is imposed. In practice, the conduct of the taxpayer during the investigation can significantly affect the size of any adjustment – cooperation is more likely to lead to a satisfactory resolution.

It has been noticed, however, that the Federal Tax Department is becoming more aggressive and is intensifying audit procedures, in particular regarding WHT in connection with hidden distribution of profits based on non-arm's-length transactions and with respect to Swiss value-added tax (VAT).

If the taxpayer disagrees with the assessment, they are entitled to make a formal appeal to the tax authorities. If the appeal is partly or entirely dismissed, then the taxpayer has the right to appeal to the Cantonal Tribunal and ultimately to the Swiss Federal Supreme Court.

The resources available to the Swiss tax authorities depend to a great extent on the canton involved. Increasingly, TP experts from within the FTA are called upon by the cantonal tax authorities, particularly in smaller cantons.

If challenged by the Swiss tax authorities, taxpayers must demonstrate that any transfer prices were based on sound economic and commercial reasoning. There is generally no publicly accessible information on which to base a local comparable study. Hence, a pan-European benchmarking analysis generally supports the defence of transfer prices in Switzerland.

Liaison with customs' authorities
The customs' authorities assess customs' duties and levy VAT on imported goods (the ordinary VAT rate is 8%). Consequently, information is regularly exchanged between the customs and VAT authorities. Since the VAT authorities themselves form a sub-department of the Federal Tax Authorities, the trend towards exchange of information between the different tax authorities in Switzerland (direct and indirect taxes as well as WHT) is increasing.

Consequently, TP adjustments should be considered for income tax and WHT as well as VAT purposes. An adjustment to the returns made for customs' duty purposes is generally not required, since Swiss customs' duty is based on weight and not on monetary value (although there are a few exceptions).

Risk transactions or industries
Generally, all transactions between related companies are equally likely to be challenged. No single industry sector appears to be more likely targeted than any other. More recently, there seems to be a trend that IP licensing transactions and transactions in connection with entrepreneur structures are more closely scrutinised.

Comparison with OECD Guidelines
Switzerland is a member of the OECD and has accepted the initial as well as all the updated OECD TP Guidelines on TP without reservation.

In an instruction issued 4 March 1997, the Director of the FTA informed the cantonal tax authorities about the contents of the OECD TP Guidelines on TP and asked the authorities to observe these guidelines when adjusting profits or when assessing multinational enterprises in the canton.

The TP landscape of Switzerland is also dependent on the updated or added guidance published by the OECD as a result of the BEPS action plan. It can be anticipated that the changes due to the BEPS project will also have an appropriate impact on the TP environment and practices in Switzerland.

Switzerland

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Taiwan

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Overview

The fact that taxpayers need to adhere to the arm's-length principle is stipulated in article 43-1 of the Income Tax Act (ITA) and is defined as adhering with 'regular business practices' in the arrangement of income and expenses, as well as profit and loss (P&L) allocation. Article 43-1 of the ITA bestows the Ministry of Finance (MOF) with authority to adjust the allocation of income and expenses, as well as P&L distribution, if it deems allocation is inconsistent with regular business practices, so resulting in tax evasion or reduction.

The MOF clarified its stance on the arm's-length principle upon enactment of the Assessment Rules for Non-Arm's Length Transfer Pricing of Profit-Seeking Enterprises (Assessment Rules) on 28 December 2004, and amended the TP Assessment Rules dated 6 March 2015. The Taiwanese tax authority must follow the Assessment Rules when undertaking adjustments and/or assessments of transfer pricing (TP) inconsistent with arm's-length transactions. The Assessment Rules serve as the main source of regulation with regard to TP in Taiwan. The tax authority will, at times, when there is a need for clarification, issue tax rulings called Tai Tsai Shuei. There are no regular circulars regarding TP in Taiwan.

Country	**Taiwan**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	When the return is filed
Must TP documentation be prepared in the official/local language?	Yes

Taiwan

Country	Taiwan
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	On profit-seeking enterprises refusing to cooperate with the investigation or submit the required documents for tax assessment, a fine no less than TWD 3,000 and no more than TWD 30,000 will be imposed. If the tax amount is underreported, a fine may be imposed no more than two or three times for the underreported amount.

Introduction

When it was included in the ITA in 1971, Article 43-1 was intended for dealing with situations where special transactional arrangements are made between related parties not complying with the arm's-length principle, thereby reducing tax liabilities in Taiwan. However, because the provision failed to explicitly specify standards to determine non-arm's-length business operations, or transactions and related (tax) adjustment methods, it was in practice difficult to follow. On 28 December 2004, the MOF promulgated the Assessment Rules, which set forth the details of the arm's-length nature of related-party transactions that should be assessed, and the relevant documentation requirements. The TP Assessment Rules were amended by the MOF dated 6 March 2015.

Legislation and guidance

TP Assessment Rules consist of 7 chapters and 36 articles, with detail in the following aspects:

- Scope of related parties.
- Codification of the arm's-length principle.
- Accepted TP methods.
- Documentation requirements.
- Advance pricing agreements (APAs).
- TP investigation and assessments.

The Assessment Rules serve as legislation addressing TP issues in Taiwan. Their scope allows the MOF, as well as the local tax collection authority, to define related parties, shape the determination of arm's-length transfer prices, authorise APAs, seek penalties against non-conforming enterprises, etc.

Any profit-seeking enterprise including a legal entity, a branch and a permanent establishment (PE), having income derived from sources in the Republic of China

is subject to TP rules. There is no set rule to exclude any types of related-party transactions. Irrespective of whether the transactions arise between related parties within national borders or cross-border, the transactions are subject to TP rules, due to the fact that even within the national border, the effective tax rate of the related parties may be different.

While Taiwan is not a member of the Organisation for Economic Co-operation and Development (OECD), the MOF nonetheless did consult the legislation and documents of the OECD member countries and other developed nations while drafting Taiwan's TP regulations, making the regulations consistent with international trends and thinking. This does not mean, however, that all the OECD regulations are applicable to Taiwan. The Assessment Rules are set, based on the OECD Guidelines and the Internal Revenue Service (IRS). A taxpayer should follow the Assessment Rules in Taiwan. Only when there are no set rules in the regulations may the taxpayer make reference to the OECD Guidelines. The tax authorities may not adopt them though.

Penalties

If an enterprise is engaged in related-party transactions, it must determine the transaction results in accordance with the Assessment Rules and use the results as its basis to determine its taxable income. Where a profit-seeking enterprise fails to comply with the rules, thereby resulting in a reduction of tax liability in Taiwan, and the collection authority in charge has made adjustments and assessed the taxable income of the enterprise in accordance with the ITA and the TP assessment regulations, a fine may be imposed. Article 110 of the ITA stipulates that in addition to the tax liability assessed, a fine will be imposed at two to three times the tax amount underreported, depending on the circumstances, for any of the following:

- The declared price of a controlled transaction is no less than two times the arm's-length price as assessed by the tax administration, or no more than 50% of the assessed arm's-length price. The increase in taxable income of the controlled transaction as adjusted and assessed by the collection authority in charge is 10% or more of the annual taxable income of the enterprise, and 3% or more of the annual net business revenue.
- The profit-seeking enterprise fails to submit a TP report and is unable to provide other documents evidencing that the results of the transaction are at arm's length.
- In other cases where evidence of tax shortfall discovered by the collection authority in charge leads to significant amount of tax omission or underreporting.

Documentation

When filing income tax returns, profit-seeking enterprises, except for those that have a turnover amount and controlled transaction amount less than the disclosing threshold established by the MOF, shall disclose information regarding their related parties and the controlled transactions with their related parties in prescribed formats.

The information required in the prescribed disclosure formats is as follows:

- Related-party organisation chart.
- Detailed list of related parties.
- Summary table of related-party transactions.
- Detailed declaration of related-party transactions.

Taiwan

A profit-seeking enterprise should prepare the following documents in Chinese when it files its income tax return, and submit them to the tax authority when requested within the submission deadline, if it is under a TP investigation:

- A comprehensive business overview.
- A description of organisational structure.
- A summary of related-party transactions.
- A TP report in Chinese unless prior approval is obtained for preparation of English TP report.
- A statement of affiliation (in the case of a subsidiary) and a consolidated business report of affiliated enterprises (of a parent company), as stipulated in Article 369-12 of the Company Act.
- Other documents concerning related parties or controlled transactions that affect pricing.

The TP report should include the following items:

- Industry and economic analysis.
- Functional and risk analysis of all the participants of the controlled transaction. Where the companies engaged in business restructuring, functional and risk analysis should be disclosed for both pre-structuring and post-restructuring situations.
- Compliance status of the controlled transaction with the arm's-length principle.
- A description of the search for comparables and relevant information of the comparables.
- A comparability analysis.
- A description of the selection of the most appropriate TP method and the related comparability analysis.
- Assessments on whether the business restructuring is conducted at arm's length if a Taiwan entity of an MNC group undergoes any business restructuring.
- The result of the TP analysis.

Profit-seeking enterprises conducting controlled transactions are generally required to prepare TP reports. However, to alleviate taxpayers' burden and compliance costs, the MOF established a safe harbour rule on 30 December 2005, and subsequently revised the safe harbour thresholds on 6 November 2008 and 2 February 2015. Profit-seeking enterprises whose controlled transactions meet the requirements regulated under the safe harbour rule may replace their TP report with other evidentiary documents, which can sufficiently prove that the results of such transactions are at arm's length.

In addition, the amended TP Assessment Rules announced on 6 March 2015 has introduced the concepts of the OECD TP Guidelines concerning business restructuring. Therefore, Taiwanese companies engaged in business restructuring (includes but is not limited to conversion from full-fledged distributors to limited risk distributors, from full-fledged manufacturers to contract manufacturers, the centralising or decentralising of ownership/management of intangible properties across different entities within the group, the downsizing or winding-up of operations, as well as any other arrangements announced by the MOF) from FY2014 onwards are required to disclose and document in their TP reports whether the restructuring was conducted in compliance with the arm's-length principle.

The applied TP methods specified by the MOF available for each transaction type are as follows:

	Tangible asset transactions	Intangible asset transactions	Provision of services	Use of funds
Comparable uncontrolled price method	V		V	V
Comparable uncontrolled transaction method		V		
Resale price method	V			
Cost-plus method	V		V	V
Comparable profit method	V	V	V	
Profit split method	V	V	V	

If the taxpayer intends to apply a TP method other than one of the previously mentioned methods specified by the MOF, pre-approval by the MOF is required.

Transfer pricing controversy and dispute resolution

Audit targets

On 2 August 2005, the MOF announced key criteria for its selection of audit targets. These criteria include any of the following:

- Profit-seeking enterprises with a gross profit margin, operating margin, or return on sales ratio that is lower than that of other enterprises in the same industry.
- Profit-seeking enterprises that make a loss or a profit far less than that of other overseas' affiliated entities, while the worldwide enterprise's group makes a profit as a whole.
- Profit-seeking enterprises whose profitability in the year under review and the previous two years, fluctuates abnormally.
- Profit-seeking enterprises that do not disclose controlled transactions in the prescribed forms.
- Profit-seeking enterprises that do not evaluate whether the result of a controlled transaction is at arm's length in compliance with Article 6 of the TP assessment regulations, or do not prepare the required evidentiary documents.
- Profit-seeking enterprises that have controlled transactions with related parties, but without a reasonable arm's-length price.
- The previous and subsequent years of income-tax filing of profit-seeking enterprises that do not provide required evidentiary documents of controlled transactions in compliance with Article 22 of the Assessment Rules upon tax authorities' TP investigation and assessment adjustment.
- Profit-seeking enterprises that are involved in significant or frequently controlled transactions with affiliated entities located in tax havens, or in countries with a low-tax rate.
- Profit-seeking enterprises that are involved in significant or frequently controlled transactions with affiliated entities that enjoy tax incentives.
- Profit-seeking enterprises that are involved in other arrangements that intend to avoid or reduce tax liabilities in Taiwan.

Audit procedure
In practice, the TP audit is combined with the assessment on the income tax return. If a profit-seeking enterprise is perceived to enter into controlled transactions that are not consistent with the arm's-length principle, it must present the evidential documentation as listed here, within one month of receiving a written notice of an investigation from the competent tax authority. Those who cannot present such documentation within the prescribed period under special circumstances must apply for an extension before the original due date. The extension may not exceed one month and is limited to one time only. Any arm's-length adjustments made by the National Tax Administration (NTA) will need to obtain final approval from the MOF. In 2014, NTA established a special TP team and target to extend the TP audit.

Should the tax authority deem it necessary to request additional supporting documents subsequent to its first review, the profit-seeking enterprise should provide the additional supporting documents within one month.

Audit procedures, assessment and corresponding adjustments
The MOF is principally responsible for setting policies and issuing statutory interpretations; the various regional bureaus of the NTA undertake the task of concrete implementation.

The NTA may choose from two approaches to conduct the investigation, based on whether the enterprises being audited provide the TP documentation as required.

If an enterprise provides adequate TP documentation, the NTA may assess its taxable income, based on such documentation.

If an enterprise fails to provide the mandated documentation, the NTA may assess the taxable income, based on the information gathered from internal and external sources.

In either case, the taxable income of the taxpayer is assessed in accordance with the regulations. However, where there is a failure to provide information regarding comparables, the NTA in charge may assess tax on adjusted taxable income, based on the standard profit margins regulated by the MOF.

If an arm's-length adjustment, approved by the MOF, is made by a NTA in charge, that NTA shall also make a corresponding adjustment to the taxable income of the counterparty of the transaction if the counterparty is subject to income-tax obligation in Taiwan.

Revised assessments and the appeals' procedure
If a taxpayer refuses to accept the tax authority's decision as final, the taxpayer may attempt to protect its interests by filing for administrative remedy and litigation.

Advance pricing agreements

The TP assessment regulations also provide rules for APAs and specify the following particulars:

- The criteria and time period for applying for an APA.
- Materials that must be provided in an application for an APA.
- Notification of significant changes in conditions and agreement termination.
- Period for audit and evaluation by the tax authority.
- Signing procedures and application period of an APA.
- Content of an APA.
- Submission of annual APA reports.
- Efficacy of an APA.
- Handling of changes in factors affecting prices or profits.
- Extension of an APA.

A profit-seeking enterprise may apply for an APA if it meets all of the following requirements:

- The total amount of the transactions being applied for under the advance pricing arrangement shall be no less than TWD 500 million, or the annual amount of such transactions shall be no less than TWD 200 million.
- No significant tax evasions were committed in the past three years.
- Documentation required for an APA application, such as a business overview, relevant information of the related parties and controlled transactions, TP reports, etc. shall be provided within the prescribed time limit.

Taxpayers deemed qualified to apply for an APA should file an application before the end of the first fiscal year covered by the APA. The collection authority in charge shall notify the taxpayer in writing within one month whether the application is accepted. Once the application is accepted, the taxpayer should provide all required documents and the related TP report within three months from the date the notification is received.

A taxpayer may officially apply for an APA pre-filing meeting with the tax authority no less than 3 months before the end of the fiscal year. Within 3 months from the date the pre-filing meeting application is filed, the tax authority should determine, and notify the taxpayer in writing whether the APA application is accepted. Where the APA application is accepted, the taxpayer should submit the required information within 3 months from the receipt of such written notice from the tax authority.

The collection authorities in charge shall review and reach a conclusion within a year. Under special circumstances, the evaluation period may be extended by six months and, if necessary, by an additional six months. There is no deadline for bilateral APA cases.

The collection authorities in charge will carry out discussions with the taxpayer in the six months following the date the conclusion is reached. An APA shall be signed between the collection authority in charge and the taxpayer, upon an agreement being reached between both parties. Once an agreement is signed, both sides are obligated to follow its terms.

During the applicable period of the APA, the taxpayer must submit an annual report on the execution of the APA to the tax authority during the annual tax filing period. The taxpayer also must retain evidential documentation and reports, as required.

Transfer pricing on permanent establishment

On 11 January 2007, the MOF issued a ruling which specifies application of TP assessment regulations when determining operating profit attributable to the PE of a foreign enterprise in Taiwan, in accordance with a double taxation agreement (DTA).

If under a DTA between Taiwan and a foreign country, an enterprise of the other contracting state has a PE in Taiwan, the profit attributable to the PE is subject to income tax in Taiwan, and should be determined in the following manner:

The PE shall be deemed as carrying out business transactions with the enterprise of the other contracting state in a capacity of a completely independent enterprise, under same or similar conditions for the same or similar activities. The income attributable to the PE shall be determined in accordance with TP assessment regulations. Sufficient documentation proving that the attribution of income to the PE is in compliance with TP rules must be ready for audit by a collection authority in charge. Where an enterprise of the other contracting state deducts for income-tax purpose the expenses incurred for carrying out the business of the PE, it should apply the Taiwanese ITA, profit-seeking enterprise income tax assessment regulations, TP assessment regulations and other relevant rules.

If the enterprise of the other contracting state attributes all income from sale of goods or provision of services in Taiwan to its PE, it is not subject to TP documentation requirements.

Management service fees

Management service fees charged to Taiwanese entities have come under scrutiny by the tax authorities. The tax authorities have challenged i) the necessity of management services, and ii) that the Taiwanese entity realised actual benefits. The burden of proof has been heavily placed on the taxpayer to persuade the tax authorities that management expenses are necessary. There is no specific outline of acceptable evidence, but detailed records of all expenses charged should be kept in the event the tax authorities challenge management charges.

94.

Tanzania

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Overview

While the Income Tax Act 2004 has always had a transfer pricing (TP) section, it is only in the relatively recent past that TP has become an area of significant focus for the Tanzania Revenue Authority (TRA). There have been an increasing number of TP-related queries in tax audits normally accompanied by a request for TP documentation.

The impetus for this change includes the following:

- Significant investment by the tax authority in terms of technical training as well as setting up a specialised International Tax Unit responsible for TP tax audits.
- Regional and global focus on TP including: (i) the Africa Tax Administration Forum (ATAF), (ii) the ongoing base erosion and profit shifting (BEPS) debate, and (iii) a proliferation of reports by non-governmental organisations (NGOs) in relation to TP issues.
- The issue in May 2014 of the Income Tax (Transfer Pricing) Regulations 2014 (the 2014 Regulations).
- The issue in June 2014 of TP Guidelines (the Guidelines).

The 2014 Regulations imposes a requirement for taxpayers to have TP documentation in place before filing their annual corporate income tax returns and imposes significant penalties.

T

Country	**Tanzania**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes

Tanzania

Country	Tanzania
When must TP documentation be prepared?	Before filing the tax return
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	100% of underpayment of tax

Introduction

Since inception the Income Tax Act (ITA) 2004 has had a requirement that transactions between associates should be undertaken at arm's length. The Income Tax Regulations 2004 issued shortly after the publication of the ITA 2004 had included a regulation that stated that the TP section in ITA 2004 'shall be construed in such manner as best secures consistency with transfer pricing guidelines in the Practice Note issued by the Commissioner'. However, until the recent issue of the 2014 Regulations and the Guidelines no such guidance had been given.

Notwithstanding the absence of regulations, recent years have seen significant focus by the TRA on TP in terms of increasing resources and training as well as conducting TP tax audits of many taxpayers. These tax audits have highlighted a number of areas of protracted disagreement between taxpayers and the TRA regarding technical matters relating to TP.

In May 2014, the 2014 Regulations were made available to provide guidance on the application of the arm's-length principle in the Tanzanian context and the compliance requirements for taxpayers. Although not released until May 2014, the 2014 Regulations are technically effective from 7 February 2014 and do not contain transitional arrangements. The TRA also released TP Guidelines in June 2014, so as to provide further guidance to taxpayers.

Although the Income Tax Regulations 2004 had included a regulation providing the possibility to enter into advance pricing agreements (APAs) and ITA 2004 contains a provision for taxpayers to obtain private rulings, such agreements were historically not requested, particularly as no formal TP regulations had been issued. The 2014 Regulations do allow taxpayers to apply for an APA and this can be unilateral, bilateral and multilateral, based on the specific requirement of taxpayers. The 2014 Regulations envisage that an APA will only be valid prospectively and for a maximum period of five years during which there are annual compliance requirements. However, there are indications of some initial reluctance to accept APA requests until the TRA are more confident of their capacity and knowledge of different industries.

The 2014 Regulations also contains some references to avoid double taxation. For cross-border transactions there are provisions to enable a corresponding adjustment in Tanzania in cases where a TP adjustment has been made by a tax authority of a country with which Tanzania has a double tax treaty (DTT). In practice, the benefit of this provision may be limited as Tanzania currently has few DTTs in place. In addition, the 2014 Regulations still make such an adjustment conditional on the Commissioner agreeing that the adjustment made by the other country is in accordance with the arm's-length principle. This unilateral approach seems inconsistent with the mutual agreement procedure (MAP) normally provided for in DTTs and suggests that it may be problematic relying on the MAP for resolving instances of double taxation.

Legislation and guidance

Section 33 ITA 2004 and the 2014 Regulations require transactions between associated parties to be undertaken at arm's length and give the Commissioner powers to make the necessary adjustments if there is reason to believe that a transaction has not been undertaken at arm's length.

Section 3 ITA 2004 defines persons and entities to be associates if either of them directly or indirectly controls or may benefit from 50% or more of the rights to income or capital or voting power of the entity. In addition, the definition includes circumstances whereby one party may reasonably be expected to act in accordance with the intentions of the other party.

The 2014 Regulations explicitly state that they apply not only to cross-border transactions but also to domestic transactions between associates. They also apply to transactions between branches and their head office or other related branches.

Transactions subject to adjustment include the sale or purchase of goods, sale, transfer, purchase, lease or use of tangible and intangible assets, provision or receipt of services, lending or borrowing of money and any other transactions that affect the profit or loss of the enterprise involved. The 2014 Regulations have specific provisions dealing with intragroup services, intangible property and intragroup financing. These provisions focus on the need to be able to demonstrate economic or commercial benefit to the business, and in the case of financing that interest rates are at arm's length.

The Guidelines state that an offshore entity cannot be the tested party unless full documentation and records of the offshore entity is made available to the TRA during a tax audit.

Although the 2014 Regulations do not contain a specific statute of limitation, TP audits have generally focused on income tax adjustments. The limitation period for raising an assessment under the ITA 2004 is three years from the due date for filing the tax return. There is, however, no limitation period in cases of fraud, intentional negligence or gross negligence. The new tax administration Act which will be effective from 1 July 2015 has increased the period for raising an assessment to five years.

Penalties

The 2014 Regulations contain significant penalty provisions for non-compliance, which include criminal sanctions.

The financial penalty for any TP adjustment made as part of a tax audit is 100% of the underpayment of tax. On the basis that the quantum of TP adjustments can be high and that there is a significant element of subjectivity in respect of TP, the penalty does appear punitive – particularly so as it would appear to be additional to other standard penalties that can be charged under the ITA 2004 (or in future under the Tax Administration Act). There is no specific guidance to cover situations where a TP adjustment solely results in reducing tax losses.

In addition, the penalty for non-compliance with TP documentation requirement is, on conviction, imprisonment for a maximum term of six months and/or a fine of not less than 50 million Tanzanian shillings (TZS).

In addition to the penalties described above, late payment interest will also apply, based on the Bank of Tanzania base rate plus 5%. The current interest rate on late payment is an annual rate of 21% compounded on a monthly basis.

The Guidelines do not contain penalty provisions; however, as the Regulations are a subsidiary legislation they are likely to be used to impute penalties for non-compliance.

Documentation

The 2014 Regulations explicitly require taxpayers with transactions with associates to have contemporaneous TP documentation to be prepared before the tax return is submitted. Although the TP documentation is not required to be submitted with the tax return, it should be provided to the tax authority within 30 days if requested.

The 2014 Regulations also state the list of information that should be included in TP documentation and these are:

- Organisation structure covering parties involved in the transactions.
- Details of the nature of the business and industry and market conditions.
- Details of the transactions.
- The assumptions, strategies and factors that influenced the setting of the pricing policies.
- Comparability, functional and risk analysis.
- The selection of the TP method and the reasons for the selection.
- The application of the TP method.
- The documents that provide support or were referred to in developing the TP analysis.
- Any other information, data or document considered relevant by the Commissioner.

The 2014 Regulations contain significant penalties for non-compliance with TP documentation.

Transfer pricing controversy and dispute resolution

The 2014 Regulations were only released in May 2014 and are effective from 7 February 2014. Therefore, no TP tax audits have yet been undertaken under the 2014 Regulations. However, there are a number of TP disputes that have been taken through the appeal process and have yet to be determined. The first stage of an appeal is with the Tax Revenue Appeals Board (TRAB). A ruling by the TRAB can be appealed to the Tax Revenue Appeals Tribunal (TRAT). A ruling of the TRAT can be appealed to the Court of Appeal, which is the final avenue for appeal.

Burden of proof

The burden of proof in Tanzania is on the taxpayer to demonstrate that the transactions with associated parties have been conducted at arm's length.

Tax audit procedures

Tax audits are normally carried out every two or three years, covering all taxes. Historically, any TP queries would arise in the course of these tax audits.

However, with the release of the 2014 Regulations and the creation of a dedicated international tax team, it is likely that TP tax audits will be undertaken separately – particularly so, bearing in mind the new requirement for taxpayers to have TP documentation in place.

Resources available to the tax authorities

A specialist International Tax Unit has been established within the Large Taxpayers Department of the TRA and it is responsible for conducting TP audits.

Significant investment has been made by the TRA in building up resources for TP audit through training locally and overseas. In addition, the TRA is a member of the ATAF and also receives extensive help from tax authorities of certain Organisation for Economic Co-operation and Development (OECD) member countries.

The TRA has also now acquired rights to use the Orbis database, which should enable them to review and perform their own economic studies.

Risk transactions or industries

There are no specific industries targeted by the TRA. Inbound management services and royalty payments are routinely queried by the TRA. There is also increasing focus on group financing arrangements.

Competent authority

The competent authority is the Commissioner for the Large Taxpayers Department. There is no information available on the process for competent authority claims, and we are unaware of the competent authority process being used in practice in Tanzania.

Although the 2014 Regulations contain provisions to enable a corresponding adjustment in Tanzania in cases where a TP adjustment has been made by a tax authority of a country with which Tanzania has a DTT, the benefit of this provision may be limited as Tanzania currently has few DTTs in place.

In addition, the 2014 Regulations still make such an adjustment conditional on the Commissioner agreeing that the adjustment made by the other country is in accordance with the arm's-length principle – a unilateral approach that seems inconsistent with the MAP normally provided for in DTTs.

Advance pricing agreements
The 2014 Regulations allows taxpayers to apply for an APA and these can be unilateral, bilateral and multilateral, based on the specific requirement of taxpayers. The Regulations envisage that an APA will only be valid prospectively and for a maximum period of five years, during which there are yearly compliance requirements.

However, there are indications of a reluctance to accept APA requests until the TRA have finished building up capacity and developed their knowledge of different industries.

Liaison with other authorities
Certain sectors are regulated by their specific regulatory bodies and in certain cases these do sometimes ask for TP documentation to validate intragroup transactions (particularly in relation to extractive sectors).

Joint investigations
The TRA is a member of the ATAF, a body that is responsible for enhancing the technical expertise of African tax authorities. It is unclear whether this has led or will lead to joint investigations by different tax authorities into a taxpayer's affairs, although it does provide the tax authorities a forum for discussions. There are, however, some informal indications that tax authorities within the region are sharing information on particular taxpayers.

Comparison with OECD Guidelines
The TP rules are based on the OECD Guidelines and are usually acceptable for determining an acceptable TP policy. The 2014 Regulations state that further guidance can be obtained from both the OECD Guidelines as well as the UN Transfer Pricing Manual for Developing Countries. There is no guidance on which of these two guidelines have priority in case of conflict and this may lead to uncertainty.

The 2014 Regulations stipulate which TP methods are available to taxpayers and these are:

- The comparable uncontrolled price (CUP) method.
- The resale price method (RPM).
- The cost plus (CP) method.
- The profit split method (PSM).
- The transactional net margin method (TNMM).
- Any other method that may be prescribed by the Commissioner from time to time.

The 2014 Regulations state that the traditional transaction method should be used in the first instance and only where it cannot be reliably applied can a transactional profit method be applied. It thereby imposes a hierarchy of method which is no longer the OECD position.

Use and availability of comparable information

There is a lack of information availability in relation to Tanzanian companies. While listed companies' information is readily available, there are very few listed companies. Information for private companies is theoretically available on request from the company registrar, but in practice, obtaining such information may not be simple. The TRA has recently been challenging the use of non-Tanzanian comparables without making adjustments, although no official guidance has been provided in respect of what adjustments should be made.

The Guidelines envisage that the benchmarking will have to cover multiple years (generally a period of three years) and will need to correspond to the financial years of the tested party, which is likely to increase the compliance burden for taxpayers as there will be a constant need to update the benchmarking. In addition, the arm's-length range cannot have a large deviation as the outliners will automatically be rejected during a tax audit.

The TRA has acquired access to the Orbis database recently and we expect them to review overseas' comparables in more detail and be able to undertake their own comparable search.

Tanzania

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Thailand

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Overview

While the corporate income tax rate in Thailand has been reduced from 30% to 23% in 2012, and to 20% up until 2015, the Revenue Department's budget has significantly increased each year. In 2015, there has been a substantial increase in transfer pricing (TP) investigation activity by the Revenue Department. TP audits which were previously under the responsibility of a special TP Team, have now been transferred to 50 general audit teams. These audit teams continue to actively perform TP investigations. In addition to its normal selection of targets for TP investigation, its strategy is to investigate, simultaneously, competitors within the same industry sector and group companies within the supply chain. Domestic as well as cross border related-party transactions have been challenged by the Revenue Department during its tax investigations.

Country	**Thailand**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Upon request within 30 days
Must TP documentation be prepared in the official/local language?	No
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	No
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	100% of tax shortfall

Thailand

Introduction

While there is no specific TP provisions under the Thai tax law, there is a general requirement that companies transact on an arm's-length basis. On 16 May 2002, the Revenue Department introduced its TP guidelines in the form of Departmental Instruction (DI) No. Paw. 113/2545. The purpose of the TP guidelines is to assist taxpayers in setting arm's-length prices for their transactions with related parties and also to assist revenue officers in reviewing taxpayers' transfer prices for compliance with the arm's-length principle.

Taxpayers are required to self-assess and file corporate income tax returns within 150 days of the last day of their accounting period. In order to ensure compliance, the Revenue Department regularly conducts business operation visits/tax investigations to review major issues and comprehensive tax audits. The burden of proof lies with the taxpayers.

During an operation visit/tax investigation, transfer prices may be reviewed. The Thai TP Guidelines set out the information/documents required to be reviewed by the revenue officers. Having well-prepared TP documentation in place reduces the risk of adjustments to prices under the general provisions of the Revenue Code, based on what the revenue officer considers to be reasonable transfer prices. In the event that an adjustment is unavoidable, transfer pricing documentation can also help mitigate the size of the adjustment.

Legislation and guidance

Statutory rules

There are only general provisions under the Revenue Code designed to guard against tax avoidance arising from transactions between related parties conducted at higher or lower than market price.

On the revenue side, the Revenue Code empowers revenue officers to:

- make pricing adjustments on the transfer of properties, rendering of services and lending of money without compensation, or with compensation below the market price without justifiable reason, and
- make adjustments on the cost price of imported goods by comparison with the cost of the same type of goods imported into another country.

On the expense side, the Revenue Code empowers revenue officers to:

- disallow a purchase of goods at a price higher than market price without justifiable reason as a tax-deductible expense
- disallow an expense that is not expended for the purpose of acquiring profits or for the purpose of business in Thailand, and
- disallow an expense determined on, and payable out of, profits after the termination of an accounting period.

These tax provisions apply to domestic as well as cross-border transactions.

Having mentioned the above, the Thai Revenue Department is in the process of introducing specific TP provisions into the tax law within 2015. In this regard, under the new requirements, the taxpayers will be required to prepare transfer pricing documentation on an annual basis. Failure to submit the transfer pricing documentation within the specific timeline would result in a penalty. Furthermore, the turnaround time for submission of transfer pricing documentation under the new tax law will be very limited as taxpayers are expected to have transfer pricing documentation ready upon request.

Components of the transfer pricing guidelines

DI No. Paw. 113/2545 has the following major components:

- Clause 1 states that a company established under Thai law or under a foreign law must calculate its net profit for the purposes of corporate income tax according to section 65 of the Revenue Code.
- Clause 2 defines the term 'market price' as compensation for goods or services or interest that independent contracting parties determine in good faith in the case of a transfer of goods, provision of services, or lending of money, respectively, which is of the same type as the related parties' transaction on the same date. In this regard, the term 'independent contracting parties' is defined as parties without direct or indirect relationships in terms of management, control, or shareholding.
- Clause 3 suggests pricing methods for determining market price, namely comparable uncontrolled price (CUP), resale price (RPM), cost plus (CP) and other methods (i.e. transactional net margin method [TNMM] and profit split method [PSM]).
- Clause 4 lists the documentation that is required to be kept at the office of the taxpayer. This documentation includes ownership structure, budget, strategy and business plan, details of related-party transactions, functional analysis, pricing policy, etc. Where taxpayers can prove through such documentation that the result of their price setting under the selected method is the market price, revenue officers are obliged to use the taxpayers' methods for determining taxable income and expense for the purpose of calculating corporate income tax.
- Clause 5 allows taxpayers to enter into an advance pricing agreement (APA) with the Revenue Department. To apply for an APA, taxpayers must submit a letter requesting an APA together with relevant documents to the Director-General of the Revenue Department in order to set the criteria, methods and conditions with which the taxpayer must comply.

Burden of proof

The burden of proof lies with the taxpayer to clear alleged TP abuses. The TP guidelines are designed to assist taxpayers in their efforts to determine arm's-length transfer prices.

In the event of a dispute, the taxpayer must be able to substantiate, with supporting documents, to the satisfaction of the revenue officers, the Board of Appeals (BOA), or the courts, as the case may be, that its transfer prices have been determined in accordance with the arm's-length principle.

Tax audit procedures

Taxpayers are not required to submit their transfer pricing documentation with their annual corporate income tax returns. They are, however, expected to submit it within two weeks to one month of a revenue officer's request.

There is no specific TP audit; it is undertaken as part of the normal tax audit process. However, the Revenue Department begins the investigation process by issuing a letter requesting taxpayers, under their supervision, to provide information and documents on the adopted TP practices. Targets are selected for investigation, based on their analysis of the tax returns submitted, and information obtained from the 'business operation visit', whereby the revenue officers visit companies under their supervision at least once a year to understand the business and ensure tax compliance.

The criteria used by the Revenue Department to select targets for TP investigation includes, but is not limited to:

- Low profits compared with competitors.
- No tax payment for an extended period of time.
- Decline in profits after a tax holiday expires/business restructuring.
- Profits in promoted business, but losses/lower profits in non-promoted business.
- Drastic fluctuations in profits from year to year.
- Varied profitability by product.
- Payment of royalties/management fees.
- Significant related-party transactions.
- Company underwent business restructuring resulting in significant drop in profit.

The TP documentation is reviewed by the Revenue Department's TP team. Based on this review and analysis, the revenue officers typically raise questions and require more detailed explanations and related documents. Depending on how well the TP practices are documented and the completeness of the supporting documents, the request for additional information and documents can take many rounds.

The Revenue Department's tax investigation process is as follows:

- Collect and analyse accounting and tax information/documents.
- Challenge and invite the taxpayer's representative to discuss the TP (and any other tax) issues identified, and possibly request additional documents.
- Review additional documents and consider explanations.
- Inform the taxpayer's representative of the Revenue Department's opinion.
- The taxpayer is requested to file amended tax returns if in agreement with the Revenue Department's opinion.
- For TP issues, the Revenue Department issues a summons to audit all taxes if the taxpayer does not accept its opinion.
- Taxpayers may enter into the appeals' process to resolve the dispute if they disagree with the tax assessment.

The Revenue Department generally requires six months to analyse the information/documents and reach a conclusion. After notifying the taxpayer of the outstanding issues, the clarification and negotiation process between the taxpayer and the Revenue Department may take an additional 3–12 months.

In a case where the revenue officers accept the taxpayer's explanations and supporting documents, the challenges will be dropped. However, the revenue officers will then generally redirect their focus to other tax issues including corporate income tax, value-added tax (VAT), withholding tax, specific business tax, etc.

In the event that the revenue officers do not accept the taxpayer's explanations and supporting documents, they will advise the taxpayer to voluntarily file amended tax returns to make the required tax adjustments and to pay a surcharge. If the taxpayer disagrees with the opinion of the revenue officers, a summons will be issued for a comprehensive tax audit. The comprehensive tax audit covers all taxes under the Revenue Code (i.e. corporate income tax, VAT and stamp duty). After having completed the audit, the Revenue Department will issue the notification of a tax assessment.

Revised assessments and the appeals' procedure
After receiving notification of a tax assessment from the Revenue Department, the taxpayer is required to make an adjustment to the tax return and pay the tax shortfall, together with the related penalty and surcharge. In the event that the taxpayer disagrees with the Revenue Department, the taxpayer is allowed to appeal to the Appeals Division of the Revenue Department. The Por. Sor. 6 form must be completed and submitted to the Appeals Division within 30 days from the date of receipt of the notification of the tax assessment.

The BOA will consider the taxpayer's argument and may invite or issue a warrant to the taxpayer, or witnesses for questioning, or to provide additional testimony or supporting evidence. The appeals process on average takes three months (not including the waiting period which could be more than one year). Upon completion, the BOA's ruling will be mailed to taxpayers.

In the event that the taxpayer disagrees with the BOA's ruling, the taxpayer may bring the case to the Tax Court within 30 days from the date of receipt of the notice of the ruling. It should be noted that if a taxpayer fails to cooperate with the Revenue Department and does not comply with the summons, the taxpayer is not allowed an appeal with the Appeals Division. Furthermore, the Tax Court will not accept an appeal case if the taxpayer fails to file the appeal with the Appeals Division.

The Tax Court normally takes one to three years to reach a verdict (not including the waiting period which could be several years). If the taxpayer disagrees with the ruling of the Tax Court, the taxpayer is allowed to appeal to the Supreme Court within one month from the date of the announcement of the Tax Court's judgment. The ruling process at the Supreme Court may take an additional one to three years (not including the waiting period).

Penalties

Additional tax and penalties
In the case of a tax assessment resulting from a comprehensive tax audit, the taxpayer is liable to a penalty equal to the additional amount of tax payable. Revenue officers have the power to reduce the penalty 50% if they are of the opinion that the taxpayer had no intention of evading taxes and has cooperated fully during the tax audit.

The Director-General of Revenue Department has the power to waive the penalty if the taxpayer can demonstrate that it cooperated fully during the audit and had no intention of evading the tax.

In addition, the taxpayer is liable to a surcharge of 1.5% per month, or a fraction thereof of the tax payable, or remittable exclusive of penalties. In a case where the Director-General of Revenue Department has granted an extension of the deadline for the remittance of the tax and the tax is paid or remitted within the extended deadline, the surcharge will be reduced to 0.75% per month, or a fraction thereof. Unlike the penalty, the surcharge may not be waived.

There will be no penalty, only a surcharge, if there is tax payable in the case of voluntary filing of an amended tax return (i.e. no comprehensive tax audit).

Documentation

Resources available to the tax authorities

The Revenue Department has all taxpayers' financial information. All taxpayers are required to file their audited financial statements together with their corporate income tax returns. The Revenue Department also has access to the Business-on-Line database, which contains key financial data of all companies registered under Thai law, as well as other databases. Other sources of information include other government agencies, such as the Customs Department, the tax authorities from treaty partners through the Exchange of Information Article, disgruntled employees, etc.

Use and availability of comparable information

Comparable information may come from internal as well as external sources. The revenue officers use internal data, if and when available, to determine whether the taxpayer's transfer prices are at arm's length.

Transfer pricing controversy and dispute resolution

Risk transactions or industries

No particular industry is more at risk of being subject to tax investigation than any other. However, as Thailand is a manufacturing base for automotive makers and electronic goods manufacturers, a relatively greater number of taxpayers in the automotive and electronics' industries have been investigated. Taxpayers in other industries, such as pharmaceuticals, consumer products, petrochemicals, computers, etc. also have been investigated.

The Revenue Department has begun to focus on the following related-party transactions as part of its investigation:

- Sales and purchases of goods, assets and services.
- Transfer and use of know-how, copyrights and trademarks.
- Management and administrative fees.
- Loan and interest payments.
- Research and development expense allocation.
- Commission payments.

Limitation of double taxation and competent authority proceedings

Thailand has entered into conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to tax on income with 59 countries. The conventions include mutual agreement procedures (MAP), whereby if a taxpayer considers that the tax assessment of one or both of the contracting states results, or will result for the taxpayer in taxation not in accordance with the provisions of the conventions, the taxpayer may present the case to the competent authority of the

contracting state. The competent authorities shall endeavour to resolve any difficulties or doubts arising by mutual agreement.

It should, however, be noted that most of the treaties that Thailand has with other countries do not allow for correlative adjustment.

In the event that a taxpayer disagrees with a tax assessment of the Revenue Department, the taxpayer is entitled to seek a ruling from the Revenue Department. The ruling process, which normally takes 6–12 months, is expected to take longer in the immediate future, due to the potential change in the process resulting from the recent political turmoil. The MAPs between competent authorities will also take much longer than in the past.

The Thai Revenue Department has completed the negotiation of a few TP MAP discussions with the National Tax Authority (NTA) of Japan in April 2012.

Advance pricing agreements

Clause 5 of DI No. Paw. 113/2545 allows taxpayers to enter into an APA with the Revenue Department. To enter into an APA, the taxpayer must submit a letter requesting the APA, together with the relevant documents to the Director-General of the Revenue Department in order to set the criteria, methods and conditions with which the taxpayer must comply. Only bilateral APA applications are accepted.

Since the issuance of the guidelines on APAs in April 2010, there has been a substantial increase in the number of APA applications in Thailand. Most of them are with Japan.

Liaison with customs' authorities

The current level of interaction between the Revenue Department and other government departments, such as the Customs Department, is low. However, taxpayers should ensure that information provided to the various Government departments is consistent.

Comparison with OECD Guidelines

OECD issues

Thailand is not a member of the Organisation for Economic Co-operation and Development (OECD). However, the tax authorities generally have adopted the arm's-length principle and authorise the use of TP methodologies (e.g. CUP, RPM, CP method, TNMM, and PSM) endorsed by the OECD Guidelines in order to determine the market price of a transaction.

The CUP method, the RPM, or the CP method are preferred over the TNMM and the PSM. However, there is no hierarchy of these three methods. Other methods may be used if the three traditional transaction methods were found to be inappropriate. There is also no hierarchy of these other methods.

Joint investigations

Cross-border cooperation is common in general tax areas. Such cooperation has tended to take the form of foreign tax authorities requesting information from the Thai Revenue Department. However, recently the Revenue Department has increasingly been requesting information support from foreign tax authorities in those countries that have entered into double taxation agreements with Thailand.

Thin capitalisation
Thailand currently has no thin capitalisation legislation.

Management services
The Thai Revenue Department is currently increasing its focus on management service fees. The point of concern is whether the management service fees that a taxpayer pays to a related party are for the direct purpose of acquiring profits for the company's business in Thailand and whether the fees paid are commensurate with the benefits received.

Service providers
All costs related to the services provided must be included in the cost base and an arm's-length markup should be added in determining the service charge.

Service recipients
Generally, service recipients need to substantiate that:

- services are rendered
- services benefit the service recipient, and
- service fee paid was consistent with the arm's-length principle.

The service recipient must have documents to support the above. Contracts and documents showing the costs incurred by the service provider are not sufficient. The service recipient should keep proper documentation in respect of the services rendered, showing that the services were for the benefit of the service recipient. A benchmarking study should also be maintained to demonstrate that the service fee (as well as other transfer prices) was consistent with the arm's-length principle.

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Turkey

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Overview

Transfer pricing (TP) has been a focus for the Turkish Tax Authority in corporate tax audits. Following the reorganisation of the tax audit department of the Ministry of Finance, new tax audit divisions have been established in the three major cities of Turkey (Ankara, Istanbul and Izmir) for conducting TP audits. The TP audits conducted by tax inspectors specialising in TP have speeded up, especially over the past two years. The hot topics that are subject to tax audits are royalty payments, intragroup financing, intragroup services and the arm's length of incurred profit margins by companies with cross-border transactions.

Since the TP audits increased, multinational companies prefer to secure their TP systems by settling an advance pricing agreement (APA) with the Ministry of Finance. Although APA applications have increased, only five unilateral APAs have currently been signed. APA requests (approx. 30 APAs are in the negotiation phase) generally include royalty payments and profit margins of Turkish entities.

Country	**Turkey**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	No (But the legislation was created based on the previous OECD model)
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	Annually by the time the corporate tax return is filed (i.e. end of 4th month following fiscal year-end)

Turkey

Country	Turkey
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	TP penalties are calculated, based on the provisions of Turkish Tax Procedure Code.

Introduction

Specific TP rules have been valid in Turkey as of 1 January 2007 under Article 13 of the Corporate Income Tax Law (the CITL) No. 5520 with the title 'Disguised Profit Distribution through Transfer Pricing'.

The regulations under Article 13 follow the arm's-length principle, established by the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), and are applicable to all financial, economic and commercial transactions, and employment relations (except for salaries) between related parties. Details on the application of Article 13 are provided in a communiqué regarding disguised profit distribution through TP.

Legislation and guidance

Statutory rules

The legal framework that defines the current Turkish TP legislation is included under the CITL and the related *communiqué(s)*.

The Turkish TP legislation is part of the Turkish CITL. The arm's-length principle is defined in line with the OECD Guidelines and Article 9 of the OECD Model Tax Convention.

TP legislation, is enacted in Article 13 of the CITL along with a detailed definition of related parties, as well as the introduction of methods to be applied in the determination of the arm's-length price. According to the law, related parties must set the transfer prices for the purchase and sales of goods and services as they would have been agreed between unrelated parties.

A comprehensive definition of what constitutes a related party is found in Article 13 of the CITL. The related-party definition of the Turkish TP regulations is very broad and includes direct or indirect involvement in management or control, in addition to the shareholder/ownership relationship. In addition to transactions with foreign group companies, it also includes transactions with entities that are based in tax havens or in jurisdictions that are considered to be harmful tax regimes by the Turkish government.

For the purposes of the CITL, the term ‘corporation’ covers:

- capital stock companies,
- cooperatives,
- public economic enterprises,
- economic enterprises of associations or foundations, and
- joint ventures.

Within this framework, the concept of ‘related party’ is broadly defined under Article 13 of the CITL No. 5520 as follows:

- Shareholders of the corporation (without any threshold).
- Legal entities or individuals related to the corporation or its shareholders.
- Legal entities or individuals that control the corporation directly or indirectly in terms of management, supervision or capital.
- Legal entities or individuals that are controlled by the corporation directly or indirectly in terms of management, supervision or capital.
- Spouses of shareholders of the corporation.
- Ascendants and descendants of shareholders or their spouses.
- Persons who are linked to shareholders or their spouses up to third degree by direct blood relationship or marriage.

Moreover, by taking into account whether the taxation capacity of the source country (the tax burden on corporate income earned in the source country to be measured by taking into account all taxes that are similar to personal and corporate income taxes) is the same with that of Turkey and the issue of exchange of information, transactions made with persons located in regions or countries to be announced by the Council of Ministers will be deemed as if they were made with related parties.

The concept of ‘related party’ is also defined under the Income Tax Law as follows:

- Wife/husband of the employer.
- Lineal kinship of the employer.
- Third-degree relatives and the relatives’ affinity by marriage of the employer.
- The companies in which the employer is a direct or indirect shareholder, the other partners of these companies and the other companies that are under the control of these companies in terms of management, supervision or capital.

The TP rules define certain methods for the determination of arm’s-length transfer prices. The methods adopted are comprehensively explained by the OECD Guidelines and are as follows:

- Comparable uncontrolled price (CUP) method
- Cost plus (CP) method
- Resale price (RPM) method

The law states that if the above-mentioned methods cannot be used by the company in certain situations, the taxpayer will be free to adopt other methods. This means that companies can also choose other methods such as the transactional profit methods of the OECD Guidelines (namely, profit split [PSM] and transactional net margin method (TNMM)) for the determination of the arm’s-length price, if they can prove that the above-mentioned traditional transaction methods cannot be used.

According to the General Communiqué No. 1, the other methods are defined as the following:

- Profit split method
- Transactional net margin method

If none of the aforementioned methods can be applied, the method determined by the taxpayer may also be used as the most appropriate method for the transactions.

Comparable uncontrolled price method (CUP)
In the CUP method, if the internal comparables are sufficient to reach an arm's-length price, there is no need to find an external comparable. If there is no internal comparable, external comparables should be used after making a comparability analysis and the necessary adjustments.

Cost plus method (CP)
In the CP method, all the direct costs and indirect costs related to service or product should be considered.

If there is a difference between the accounting systems of related and unrelated transaction processes, the necessary adjustments should be made.

Resale price method (RPM)
The RPM evaluates the arm's-length character of a controlled transaction by reference to the gross profit margin realised in comparable uncontrolled transactions, and is most useful where it is applied to sales and marketing operations, such as distributors.

Profit split method (PSM)
The PSM is based on the distribution of the operating profit or loss among related parties according to their functions performed and risks assumed within the contribution analysis.

Transactional net margin method (TNMM)
The TNMM is applied according to the net profit margins that are found by considering the costs, sales or any other appropriate base.

Tax havens
In addition to inter-company transactions between related parties, the TP provisions of the CITL cover transactions between unrelated parties where the foreign party is located in one of the tax havens to be identified by the Turkish Council of Ministers. However, such a list has not been published yet as of 28 April 2015.

Payments for services, commissions, interest and royalties to parties located in a tax haven are subject to a 30% withholding tax (WHT) under the CITL. However, if the transactions involve the import of a commodity or the acquisition of participation shares or dividend payments, the WHT is not applicable as long as the pricing is considered to be at arm's length.

Deemed dividends

When it is determined by tax inspectors that the price applied in a related-party transaction is not at arm's length, the outcome is a tax adjustment on a corporate tax base as well as additional withholding tax on the disguised profit amount which is characterised as deemed dividend. This requires that if the counterparty is a non-resident taxpayer, individual or any tax-exempted corporation/person, withholding tax should be paid over the disguised profit amount.

Adjustments

Any TP-related adjustments deemed necessary by the tax authorities will be made to the taxpayers' earnings after they have paid their respective corporate taxes.

Disguised profit distributions through TP are not accepted as deductible for CIT purposes. The corporate tax base of the taxpayer will be adjusted, and relevant corporate tax will be recalculated together with the penalties and late payment interest.

Besides, the disguised profit, which is wholly or partly distributed to a related party, will be treated as:

- a deemed dividend, if the corporation distributing the disguised profit is a resident taxpayer
- a remittance, if the corporation distributing the disguised profit is a non-resident taxpayer; and
- transferred revenue, under the Income Tax Law.

In these cases, the amount of disguised profit will be subject to a WHT. However, pursuant to Article 5(1)(a) of the CITL No. 5520, if the related party receiving the disguised profit is a resident corporate taxpayer, the disguised profit amount will be evaluated within the context of 'participation exemption'. Accordingly, no WHT will be imposed and adjustment will be made on the tax return.

Intragroup services

Although in the past the law did not provide definitive legislation relating to intragroup services, the new TP article takes the OECD Guidelines as a basis. Through these developments, intragroup services may be subject to greater scrutiny under the TP regulations.

As per Turkish TP regulations, intragroup services refer to one of the following:

- The services performed by the corporate headquarters to other related-group companies.
- The services rendered by one group company to another.

These services are usually considered as services that ensure intragroup management, coordination and control functions. The costs of these services are undertaken by the parent company, a group company that is responsible for this purpose, or another group company (group services centre).

From the perspective of Turkish TP regulations, the following points have to be taken into consideration:

- Whether the service has been actually rendered.
- Whether the receiver company(ies) needs the service.
- Whether the price of those services is at arm's length.

Because of the uncertainty of management services and their prices, intra-group service fees are always an easy target for the tax audits to attack. The payments that fail to fulfil the above-mentioned points may be criticised from a TP point of view and may be treated as non-deductible for CIT purposes. In addition to this, in recent tax audits Turkish tax inspectors began to re-characterise the service fees paid abroad as royalty payments by claiming that those services received from related parties in fact include the transfer of know-how and accordingly criticised the taxpayers from WHT perspective.

Penalties

There are no specific TP penalties. The penalty provisions of the Tax Procedure Code apply to those who do not submit the required documentation and/or where transactions are found to be inconsistent with the arm's-length principle. Briefly, if the profit that is distributed in a disguised manner through TP shall be deemed as dividends distributed, then necessary adjustments on taxes will be made at the hands of the party receiving the deemed dividends. In this respect, the taxes assessed in the name of the company distributing dividends in a disguised manner must be finalised and paid.

There is no specific tax loss penalty in Turkish tax legislation for TP adjustments. The general tax loss penalty provisions in the Turkish tax procedural law are applicable. The general tax loss penalty is equal to one-fold of the unpaid tax. In case of repetition, it is applied as 1.5-fold of the unpaid tax.

Additionally, there is a default interest applied on a monthly basis (1.4% effective from 19 November 2010) for the period between the normal due date of the additional tax assessed and the date of assessment. Further, there is no specific reduction provision for TP-related tax loss penalty assessments; general rules in the Turkish Tax Procedure Code are applicable. Taxpayers may appeal to the Ministry of Finance for a reduction in the tax loss penalty through reconciliation procedure with the tax authorities either before or after the imposition of the assessment.

Documentation

The legislation requires documentation as part of the TP rules wherein.

Turkish taxpayers should keep documented evidence within the company in case of any request by the tax authorities. The documentation must represent how the arm's-length price has been determined and the methodology that has been selected and applied through the use of any fiscal records and calculations, and charts available to the taxpayer.

The TP regulations in Turkey have three basic documentation requirements:

- Electronic corporate tax return form about TP, controlled foreign company and thin capitalisation.
- Annual TP report.
- TP documentation for taxpayers during the application of an APA and annual report for taxpayers under an APA.

According to General Communiqué No. 1, all corporate taxpayers should submit a form as an attachment to their annual corporate tax return. The form constitutes the following parts:

- Information about the taxpayer (tax ID number, corporate name, taxation period, etc.).
- Information about the related parties within the scope of the form (corporate name, country of residence).
- Total amount of transactions that occurred between related parties.
- The methods used for the related-party transaction.
- Information about the controlled foreign company of the company (corporate name, country of residence, etc.).
- Information about thin capitalisation.

On the other hand, corporate taxpayers are obliged to prepare an annual TP report in line with the format that is stated in the General Communiqué No. 1. An annual TP report should be prepared until the last day of CIT declaration day, which is 25 April for taxpayers whose fiscal year is a calendar year. The report shall compose different levels of information depending on:

- whether the taxpayer is registered to the Large Taxpayers Tax Office, and
- whether the taxpayer is operating in free trade zones (FTZ) in Turkey.

According to the above-mentioned distinction:

corporate taxpayers that are registered to the Large Taxpayers Tax Office must prepare a report that comprises information about both their domestic and cross-border related party transactions as well as their transactions with related parties operating in Turkish free trade zones (FTZ), and

- corporate taxpayers that are operating in FTZs in Turkey must prepare a report that comprises information about their transactions with their related parties in Turkey.

All other Turkish corporate taxpayers must prepare a report that comprises information about their cross-border-related party transactions as well as their transactions with related parties operating in Turkish FTZs.

Documentation deadlines are as follows:

	Preparation deadline	Submission deadline
TP form	-	Corporate tax return submission (as an attachment to the corporate tax return) on the 25th day of the fourth month following the end of fiscal year
Annual TP report	Corporate tax return submission on the 25th day of the fourth month following the end of the fiscal year	15 days upon request by tax authorities

Disposition of the annual TP report is mentioned in the related legislation as follows:

- General information: Information about the field of activity of the taxpayer, economic conditions in this field, market conditions and business strategies.
- Information about related parties: Information about tax ID numbers, addresses, telephone numbers, etc. of the related parties and the field of activity of the related parties as well as economic conditions in this field, market conditions and business strategies, functions undertaken, risks assumed and assets employed.
- Information about the details of related-party transactions: Detailed information about all transactions and agreements between related parties.
- Information about TP analysis: Detailed information about comparability analysis, criteria that are used to choose for the comparable transactions (whether there are adjustments on the determination of the comparability of the detailed information for that; information, documentation and calculation that shows the applied TP method is the most appropriate as well as the comparison of the applied method to the other methods; detailed information about the calculations used to find the arm's-length price or profit margin; whether an arm's-length price range is determined, and the detailed information on this range).
- Conclusion: A summary includes the methods and arm's-length prices of the intercompany transactions.

Taxpayers that apply for an APA shall prepare application documents, and once an APA is concluded with the Revenue Administration, the taxpayer shall prepare a separate annual report that takes TP into consideration from the APA's point of view. The documents and information required for the annual report of APA is separately defined in the legislation.

The administration can demand additional information and documents for the annual TP report, the APA application and other corporate taxpayers that have related-party transactions when regarded necessary. If the documents are written in a foreign language, their translation into Turkish is obligatory.

Other documents

In case of request by Turkish tax authorities, corporate and individual income taxpayers must prepare TP documentation regarding their related party transactions for which they are not obliged to prepare an annual TP report. The type of information that is required is outlined in General Communiqué No. 1 as follows:

- Organisation chart and definition of the company's activities, definition of related parties (tax ID numbers, addresses, telephone numbers, etc.) and property relations among them.
- All the information that includes the functions undertaken and the risks assumed by the company.
- The product price lists in the transaction year.
- The production costs in the transaction year.
- Invoice information and the number/value of transactions made with related or unrelated parties in the transaction year.
- All the contracts with related parties in the transaction year.
- Financial statements of the related parties.
- Internal pricing policy of the company, which is applied to related-party transactions.
- The associated information if related parties use different accounting standards and methods.
- Information related to the ownership of intangible property and amounts received or paid for intangible rights.
- Reason for choosing the TP method applied and informative documents related to the application of the TP method (internal and/or external comparability analysis).
- Calculations used to determine the arm's-length price or profit margin and detailed information related to assumptions.
- Method used to determine the arm's-length price range, if any.
- Other documents used to determine the arm's-length price.

Transfer pricing controversy and dispute resolution

Legal cases

In recent years, the Tax Audit Board at the Turkish Ministry of Finance has significantly increased its number of TP audits against companies. In the course of these audits, the Tax Audit Board has focused on the following TP issues:

- Continuous losses in previous years by companies that operate primarily through related companies abroad.
- Management fees and indirect cost allocations.
- Royalty payments.
- Intragroup financing.
- Intragroup services.
- Year-end adjustments.
- Arm's lengthiness of incurred profit margins.

It is expected that the companies will face different levels of tax audits under the subject of TP in the coming couple of years as the current rules seem to become a trendy subject to the tax inspectors.

Burden of proof
In Turkey, the burden of proof lies with the party making the claim under Article 3 of Turkish Tax Procedural Code. Establishing proof includes an examination of the substance of the business event that gives rise to the transaction.

According to the requirements of the TP regulations, companies should be ready to provide evidence in order to explain why they chose to implement a specific TP method. Moreover, responsibility for safe-keeping of the workings/accounts and sheets for this issue rests with the taxpayers.

In the case of a tax audit, if the tax inspector claims the application of the TP method by the company is against the law, then the burden of proof will shift to the inspector. If a situation is claimed to be clearly lacking in economic, commercial and logical justification, the plaintiff is liable to prove his claim.

Tax audit procedures
The structure of the Tax Audit Board has changed recently and the tax audits are conducted within the four categories, which are small and medium-sized companies, large companies, tax frauds, and thin cap-TP-income earned abroad. The taxpayers that are registered to the Large Taxpayers Tax Office are always monitored by the tax inspectors. A few TP audit divisions at the Tax Audit Board have been established in three major cities of Turkey (Ankara, Istanbul, Izmir) for conducting only TP audits.

Revised assessments and the appeals procedure
Assessments are made by the tax inspectors at the end of the tax audit. There is no administrative appeals' procedure , but a special reconciliation with the tax authorities is available. Likewise, the taxpayer can choose not to reconcile prior to the reconciliation process, and go to court.

Resources available to the tax authorities
During the tax audits, tax returns of the comparable companies may be used by the tax authority. Besides, there is a special unit under the Turkish Revenue Administration to deal with TP issues such as APAs and tax rulings. Both the local tax inspectors and the TP specialist tax auditors pose a high level of industry-specific knowledge, and they may use a variety of sources for benchmarking, such as financial data published by listed companies as well as data from other taxpayers (secret comparables).

As mentioned in the Documentation requirements section, above, by using the TP form attached to annual corporate tax return, inspectors may assess the amount of related-party transactions in a year and initiate an investigation accordingly.

Moreover, Turkish tax administration makes a desktop review in order to select companies for inspection, based on a digital risk analysis tool. Although details of the system are not publicly available, we are informed that amount of related-party transactions, intragroup financing, sales discounts, continuous loss-making over the years and type of related-party transactions (e.g. intragroup services), are some of the parameters used in this tool.

Accordingly, the number of TP audits has been increasing in recent years and it is expected to continue. Besides, tax authorities might request the TP reports, even if there is no TP audit. The number of companies that are requested to submit their TP report to the tax authorities has increased dramatically in recent years. Lastly, in many cases TP audits may trigger VAT and customs-related audits.

Use and availability of comparable information

As previously mentioned in the statutory rules section, above, taxpayers may use both internal and external comparables. However, available local data in Turkey is limited because only publicly held companies and certain companies with a specific amount of turnover are obliged to declare their financial data.

Turkish TP legislation neither provides a clear guidance on benchmarking studies nor prohibits the use of foreign databases.

Therefore, it might be inferred that foreign comparables should be acceptable, provided that differences in geographic markets (if any) can be eliminated through appropriate adjustments and/or analyses. Besides, comparable company sets should be updated on an annual basis according to the most recently available data.

An important point to be considered for Turkish taxpayers regarding the use of 'publicly available comparable data' for the purpose of benchmarking is when determining TP-related assessments, Turkish tax auditors would tend to use their own 'secret comparables' to which only they have access, by virtue of their public authority. Turkish taxpayers are advised to be ready to challenge this approach, which is contrary to the relevant OECD principles.

Limitation of double taxation and competent authority proceedings

Turkish tax treaties (currently with 74 jurisdictions) contain relevant mutual agreement procedure (MAP) articles. Countries that have signed a double tax treaty (DTT) with Turkey may, in theory, pursue competent authority relief as a means of preventing double taxation arising from tax adjustment. However, in practice there are very rare cases where MAPs are initiated, meaning that the MAP has been rarely tested by Turkish taxpayers as a means of preventing double taxation.

Advance pricing agreements

As part of the new TP legislation, the APA program is introduced for taxpayers who are willing to get advanced certainty with respect to their TP issues. An APA provides advance approval on the determination of arm's-length prices or TP methods used for the determination of such prices for intercompany transactions. It is stated in the TP legislation that agreements concluded with the Turkish tax authorities in this respect will be valid for a three-year period.

The APA regulations lay down the procedure whereby a taxpayer can get advance certainty with respect to TP issues in such transactions. The taxpayer can conclude the APA on a unilateral, bilateral or multilateral basis. The APA program is in line with the OECD TP Guidelines.

The scope of an APA application is limited to cross-border related-party transactions and transactions with related parties operating in Turkish FTZs. On the other hand, there is no limitation regarding the type of related party transactions and hence the taxpayer has flexibility to apply for an APA covering any type of intercompany transactions (i.e. goods and service transactions, borrowing and lending, royalty payment etc.). The APAs are effective as of the signing date of the agreement and hence are applicable for future periods. The application must include full TP documentation, fulfilling the requirements of the TP regulations.

The APA process begins with the written application of the taxpayer after application fee (50,202.80 Turkish liras [TRY] for 2015) is paid. The taxpayer submits to the Turkish Revenue Administration (TRA) the requested information and documents with the application. Information and documents submitted are subjected to a preliminary assessment by the TRA. If the information and documents do not allow the TRA to make a sufficient assessment, the TRA may request additional information and documents or meet with the taxpayer.

Following the completion of necessary data, an analysis is made regarding comparable transactions, assets used, applicable methods, agreement terms and other relevant aspects. As a result of the analysis, the TRA may accept the taxpayer's application as it is or approve it on condition that necessary modifications are made, or reject it.

Nine months prior to the end of the validity of the agreement, a taxpayer may apply for its renewal.

In view of practices throughout the world, it is observed that the APA process changes according to the complexity level and type (unilateral, bilateral or multilateral) of the agreement and completion of the process cannot be completed earlier than 18 to 36 months on average.

On 1 April 2015, TRA published a draft APA Guideline with the aim of informing corporate taxpayers planning to apply for an APA. In this context, more specific information is provided by TRA than those listed in the current TP legislation especially in terms of detailed information to be submitted by the taxpayers in their APA application, such as attachment of any relevant tax audit reports, any other APAs concluded by the foreign related parties, any relevant cost contribution agreements, provision of financial statements according to Turkish GAAP etc.

Anticipated developments in law and practice

Regarding legislation, since Turkey undertakes the G20 presidency in 2015, it is anticipated that there may be some developments in law by considering the outputs of OECD Base Erosion and Profit Shifting Action Plan, which is an important OECD/G20 project against tax avoidance by multinational companies. With respect to the practice, the Turkish tax authorities have been focusing on TP applications of the taxpayers and this approach is expected to continue in the coming years. In this respect, a new TP unit that consists of TP auditors has been established under the roof of the Ministry of Finance. In line with this development both the TP tax audits and the number of companies that have been asked to submit their TP reports has increased dramatically in the last years.

Liaison with customs' authorities

The customs' rules in Turkey are not specifically coordinated with the TP rules. The customs' authorities have their own legislative guidance for the treatment of inter-company transfers of imported/exported material. Additional TP regulations may create the need to incorporate customs' practices into joint legislation. There have been joint efforts by customs and tax authorities to work on the transactions and to investigate import prices in specific industries. For example, reports have been written by a customs' inspector that challenged import prices.

Comparison with OECD Guidelines

The Turkish TP legislation is incorporated, based on the former 1999 version of the OECD Guidelines. Although the OECD Guidelines were updated in 2010, no amendment has been made in Turkish legislation.

97.

Turkmenistan

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Overview

Legislation on transfer pricing (TP) in Turkmenistan is currently in the early development stage. The Turkmenistan Tax Code contains provisions concerning monitoring of TP. According to these rules, tax authorities monitor and adjust prices in respect to certain types of transactions including transactions between related parties, foreign trade operations and transactions where the tax authorities, during tax audits, perceive considerable deviation from the market price (i.e. more than 20%).

The Tax Code only establishes the right of the tax authorities to adjust transaction prices for tax purposes, but lacks other regulations necessary to apply the TP concept in practice (e.g. documentation requirements, detailed price benchmarking guidelines, reporting obligations, etc.).

Country	**Turkmenistan**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	No
TP documentation	
Can TP documentation provide penalty protection?	N/A
When must TP documentation be prepared?	N/A
Must TP documentation be prepared in the official/local language?	N/A
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	N/A
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Turkmenistan

Introduction

Turkmen legislation contains provisions concerning the state supervision of TP. The new Turkmen TP rules, enacted on 1 November 2004 as part of the Tax Code, include provisions that allow the tax authorities to monitor and adjust prices of certain transactions including transactions between related parties, foreign trade operations and transactions where the tax authorities perceive a deviation from the market price by more than 20%.

There are no other legislative documents on TP in Turkmenistan; therefore, the current approach lacks further clarity and preventive measures for taxpayers.

Legislation and guidance

Scope

As per TP provisions, tax authorities can apply them in respect to any transactions where they believe that there is a significant deviation of the prices of goods or services as compared to the market price. The provision remains extremely broad in scope, primarily because TP control extends to transactions involving unrelated parties. Therefore, tax authorities are empowered to execute control over prices applied for all transactions of the taxpayers including those between related, as well as unrelated, parties. However, in practice, tax authorities apply TP provisions only to cross-border transactions involving sale of goods.

Under the TP regulations, during a tax audit the authorities may determine that a particular transaction has been priced based on tax motivated decisions. In this case they are empowered to make an adjustment in order to ensure that such prices are consistent with market prices, and to readjust the corporate tax calculations accordingly.

Related parties

Related parties are defined by the Tax Code as individuals and (or) legal entities, if their relationships may affect terms or economic results of their activity.

Pricing methods

The legislation on TP lacks extensive details on methods or approaches, which tax authorities should use when they define the market price. The Tax Code provides that the real market price of goods (works, services) should be the price established by demand and supply for identical goods (works, services) or, in their absence – similar goods (works, services) in comparable conditions. The Tax Code further provides for three methods of defining the real market price:

- The method whereby the wholesale market price is defined, based on the retail price (provided by statistics' authorities), reduced for established margins up to 15%.
- The method where the market price is defined based on the resale price (resale price method).
- The method where the market price is defined, based on the cost incurred with the addition of a margin for the seller's activity consistent with that which would be earned by a third party.. This method is applied only if it's impossible to use the above two methods.

In practice, we observe that tax authorities use price indices established by the State Statistics Office of Turkmenistan or State Commodities Exchange of Turkmenistan when they define the market price. Such information on prices is usually outdated and (or) understated. In such situations, taxpayers often experience difficulties with convincing tax authorities to rely on other independent/third-party sources on pricing.

Control approach of the tax authorities
The tax authorities carry out the TP control during tax audits.

Apart from the tax authorities, the cross-border trade contracts (except the ones that fall under Petroleum Law) are subject to the mandatory state registration at the State Commodities Exchange of Turkmenistan. The State Commodities Exchange of Turkmenistan has a right to monitor the prices of goods for significant (more than 20%) deviation from market price and has a right to request the price adjustments. In practice, the fact that contracts are registered at the State Commodities Exchange of Turkmenistan may make them less likely to be reviewed from a TP perspective by the tax authorities in the case of a tax audit.

Risk transactions or industries
Goods imported by companies operating under Petroleum Law are at the highest risk of examination from a TP perspective as the contracts under such transactions are not required to be registered at the Commodities Exchange of Turkmenistan.

Anticipated developments in law and practice
Currently, there are no discussions on further developments in TP legislation as this is a relatively uncommon focus area for tax authorities.

Liaison with customs' authorities
The Customs Code of Turkmenistan contains pricing rules that allow the customs' authorities to adjust the declared import or export value of cross-border transactions for customs' payments (customs' duty or excise) purposes. Apart from available pricing methods, the customs' authorities commonly use the pricing method involving data on comparable goods and services.

Thin capitalisation
Current Turkmen legislation does not provide for any thin capitalisation rules.

Penalties
As a result of the application of the TP provisions, tax authorities may adjust prices leading to the assessment of additional taxes including corporate income tax, value-added tax and excises.

The Tax Code as well as the Administrative Violations Code of Turkmenistan does not provide for specific fines for the violation of TP legislation. Hence, taxpayers are kept liable for understatement of taxes, which entails an administrative fine of up to 40% of the additionally assessed tax. Additionally, there is also late payment interest at the rate of 0.03% per day of delay.

Documentation
Turkmenistan does not currently have TP documentation requirements.

Transfer pricing controversy and dispute resolution

Legal cases

The most common legal cases on TP matters involved appeals of export manufacturers as well as taxpayers operating under the Petroleum Law of Turkmenistan in relation to the cross-border supply of goods.

Burden of proof

In practice, the burden of proof is shifted to the taxpayer.

Tax audit procedures

There are no separate TP audit rules, but tax authorities conduct TP controls during the regular tax audits.

Revised assessments and the appeals' procedure

The taxpayer can file an appeal regarding the tax authorities' decisions on TP to a higher level tax authority as per the regular appeal procedures prescribed by the Tax Code of Turkmenistan. In case the appeals are not satisfactory, the taxpayer has a right to appeal to the relevant Turkmen courts.

Joint investigations

The Turkmen tax authorities have a right to request information on TP from the competent authorities of other states having effective double tax treaties with Turkmenistan (currently 28 states).

Comparison with OECD Guidelines

Turkmenistan is not a member of the OECD; therefore, the OECD interpretations cannot be used for TP purposes in Turkmenistan.

98.

Uganda

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Overview

The Uganda Revenue Authority (URA) has increased its focus on transfer pricing (TP), particularly since July 2011 when the TP regulations were introduced.

The Income Tax (Transfer Pricing) Regulations 2011 (the TP Regulations) introduced TP documentation requirements in respect of cross-border transactions as well as domestic transactions whose value exceeds 500 million Ugandan shillings (UGX) (approximately 200,000 United States dollars [USD]). The TP Regulations were reinforced in 2012, through the issue of a Practice Note in May 2012 (the PN), which outlines documentation that should be kept by taxpayers in support of transactions with associated parties.

Since then, the URA embarked on a campaign of enforcing compliance with the TP Regulations by requesting taxpayers to complete an associated party disclosure form and declaration, which has since been followed by several requests for TP documentation. Currently, there are a number of ongoing TP investigations, which have more than tripled since 2011.

Internally, the URA has strengthened its TP resources through capacity building programmes, participation in Organisation for Economic Co-operation and Development (OECD) seminars as well as engaging external TP specialists.

Country	**Uganda**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes

U

Uganda

Country	Uganda
When must TP documentation be prepared?	Prior to the due date of filing the income tax return for year of income
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Liability is for six months' imprisonment or a fine not exceeding 25 currency points (approx. USD 200) or both. Corporate tax penalties will also apply on any tax due at a rate of 2% per month.

Introduction
Sections 90 and 91 of the Uganda Income Tax Act allow the Commissioner to distribute, apportion, and allocate income, deductions or credits between the taxpayers as is necessary to reflect the chargeable income that the taxpayers would have realised in an arm's-length transaction. Further, the Commissioner may recharacterise a transaction that was entered into as part of a tax avoidance scheme.

To operationalise the above sections, the TP Regulations were introduced in 2011 and came into effect on 1 July 2011, followed by the PN. The TP Regulations contain the TP documentation requirements as well as penalties for lack of documentation. The PN contains documentation requirements that should be kept by taxpayers in support of their TP arrangements. Since the issue of the PN, the URA has been aggressive in following up compliance with the TP Regulations as evidenced by requests made to various taxpayers to submit their TP documentation.

Legislation and guidance
As noted above, the TP Regulations were published in 2011 and the PN was issued in 2012. The TP Regulations apply to both cross-border and domestic controlled transactions.

The key provisions of the TP Regulations are as follows:

Application to branches
For the purposes of the TP Regulations, branch persons are deemed to be separate and distinct persons from the headquarter person and the two are deemed to be associates under TP Regulation 5.

Application of the OECD Guidelines

TP Regulation 6 provides for the application of the TP Regulations in a manner consistent with the arm's-length principle under the OECD Model Tax Convention on income and capital as well as the OECD Guidelines for multinational enterprises and tax administration as supplemented and adopted from time to time.

However, in case of any inconsistency, the Income Tax Act takes precedence over the OECD Guidelines.

Documentation

Taxpayers are required to record in writing, sufficient information and analysis to verify that the controlled transactions are consistent with the arm's-length principle. TP documentation should be in place at the date of filing the income tax return for that year.

Advance pricing agreements (APAs)

The Commissioner may enter into an APA to establish an appropriate set of criteria for determining whether a taxpayer has complied with the arm's-length principle for certain future controlled transactions undertaken by the person over a fixed period of time.

Corresponding adjustments

The Commissioner may make an adjustment (where a competent authority in another country with which Uganda has a double tax treaty) to the taxation of the transactions of a person subject to tax in Uganda, and the adjustment results in the taxation in another country of income or profits that are also taxable in Uganda.

The Commissioner shall upon request by a person subject to tax in Uganda, determine whether the adjustment is consistent with the arm's-length principle and where it is determined to be consistent, the Commissioner shall make the corresponding adjustment to the amount of tax charged in Uganda on the income or profits, so as to avoid double taxation.

Penalties

The TP Regulations provide that a person who fails to comply with the TP documentation requirements is liable, in the instance of a conviction, to imprisonment for a term not exceeding six months, or to a fine not exceeding 25 currency points (approx. USD 200), or both.

The penalties under the TP Regulations result from non-compliance with the arm's-length principle and the documentation requirements. Accordingly, compliance with the arm's-length principle and documentation requirements is the first step to mitigate the risk of penalties.

Corporate tax penalties will also apply on any tax due at a rate of 2% per month.

Documentation

The PN provides guidance on the kind of documentation that taxpayers should keep in support of their TP arrangements.

Broadly speaking, the documentation requirements are consistent with the OECD requirements and some of the requirements include:

- Company details including ownership and organisational structure, operational aspects of the organisation, etc.
- Details of transactions with related parties – this includes details of the related parties involved, the type, value and timing of the transactions; a description of the comparables; risks assumed; economic conditions existing at the time that the transactions were undertaken, etc.
- Determination of the arm's-length price including a description of the method selected, functional analysis of the risks performed.
- Summary and conclusion as to whether the related-party transactions comply with arm's-length principle.

Transfer pricing controversy and dispute resolution

Tax audits

During 2013, the URA started to carry out routine TP and as a result, the tax officers have become more experienced. A lot of the investigations have focused on transactions involving the payment of management fees and royalties.

Multinational entities should expect to be called upon to affirmatively demonstrate how they set their inter-company prices. Requests to produce supporting documentation within 14 days have become a standard feature at the commencement of such examinations.

Increased disclosure requirements

In 2013, the URA rolled out the associated party disclosure form to taxpayers. Taxpayers who receive this form are required to provide extensive detail about all transactions with associated parties. Taxpayers are also required to sign a declaration to the effect that transactions were conducted in accordance with the arm's-length principle and that the relevant TP documentation is in place.

The information that is provided by taxpayers is used by the URA to determine whether a further TP investigation is necessary.

Advance pricing agreements

Although the TP Regulations provide for APAs, procedural guidance has not been issued in this regard. Therefore, the APA provision has not been tested. However, taxpayers who wish to enter into an APA can apply to the URA by way of a formal letter, setting out the circumstances and facts under which an APA is sought.

99.

Ukraine

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Overview

Transfer pricing (TP) rules came into force in Ukraine on 1 September 2013 and are mainly based on the Organisation for Economic Co-operation and Development (OECD) approach. The TP rules define related parties, provide criteria for controlled transactions, describe the methods and information sources for determining the arm's-length price for tax purposes in controlled transactions, and introduce mandatory reporting and documentation requirements for substantiating prices applied. In order to comply with the TP rules, taxpayers have to develop procedures for collecting and processing information on prices, ensuring that prices in controlled transactions are at arm's length, as well as preparing and submitting all necessary reporting documents to the tax authorities by the set deadlines. The TP rules introduce a special TP audit, as well as the possibility of concluding an advance pricing agreement (APA) with the tax authorities.

Country	**Ukraine**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes (for 2013 and 2014); No (for 2015 onwards)
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Within one month after the tax authority's request. Such request can be made no earlier than 1 May of the year following the reporting year.

Ukraine

Country	Ukraine
Must TP documentation be prepared in the official/ local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation? requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Non-submission (or late filing) of a TP report (notification on controlled transactions) – 100 minimum monthly salaries (approximately 4,900 euros [EUR]) Non-submission of TP documentation – 3% of the controlled transaction value (limited to 200 minimum salaries [approximately EUR 9,800]) Failure to declare the controlled transaction in the TP report – 5% of the controlled transaction value Tax assessed by tax authorities – up to 50% of the amount of tax assessed Self-adjustment – 3–5% of the adjusted amount of the tax liability. Tax assessed by tax authorities for the period from 1 September 2013 till 31 December 2014 – the nominal fine of 1 Ukrainian hryvnia (approximately EUR 0.04). Self-assessed tax for the period from 1 September 2013 till 31 December 2014 – no penalties is applied.

Introduction

For many years, Ukrainian TP rules contained only some basic concepts of TP, but lacked methodology and guidance for the practical implementation of them. As a result, TP regulations did not function properly in Ukraine. On 1 September 2013, TP rules, which are more closely aligned with OECD Guidelines, came into force in Ukraine. On 28 December 2014, the Parliament of Ukraine adopted the ‘Law on Changes to the Tax Code of Ukraine in respect of improvement of the tax control on transfer pricing’. The provisions of the Law came into force on 1 January 2015. The Law provides significant changes in respect of determination of related parties and controlled transactions, as well as transfer pricing audit procedures. It also provides clarifications in respect of application of transfer pricing methods, transfer pricing documentation and reporting requirements, advance pricing agreements (APAs), etc.

Legislation and guidance

Controlled transactions

The following transactions were subject to TP regulation in 2013/2014:

- Transactions of taxpayers with related parties that are non-residents of Ukraine.
- Transactions of taxpayers with related parties that are residents of Ukraine and:
  - declared tax losses for the previous tax year
  - apply special tax regimes as of the beginning of the tax year
  - apply corporate profit tax (CPT) and/or value-added tax (VAT) rates other than the standard rates at the beginning of the tax year,
  - are non-CPT and/or non-VAT payers at the beginning of the tax year.
- Transactions with residents of low tax jurisdictions (where the CPT rate is below the Ukrainian rate by 5 percentage points) or non-residents of Ukraine, which pay CPT at the rate which is below the Ukrainian rate by 5 percentage points. The list of the low-tax jurisdictions has been set by the Cabinet of Ministers of Ukraine (CMU).

The threshold for controlled transactions performed in 2013/2014 is the equivalent of 50 million Ukrainian hryvnia (UAH) (approximately EUR 3 million as of the end of 2014), net of VAT (this applies cumulatively for all transactions with one counter-party per year).

Starting from 1 January 2015, the list of controlled transactions for transfer pricing purposes (from the CPT perspective) is as follows:

- Business transactions that have an impact on taxable profits, with related parties that are non-residents of Ukraine.
- Sale of goods through non-resident commissionaires.
- Business transactions that have an impact on taxable profits, with residents of jurisdictions determined by the CMU on the following criteria:
  - States (territories), where the CPT rate is less than the Ukrainian rate by 5 percentage points.
  - States, which do not publicly disclose information regarding ownership structure of legal entities.
  - States, which do not have international agreements with Ukraine containing provisions on exchange of information.
- A business transaction between related parties through a non-related intermediary is considered, if such intermediary does not perform significant functions, does not use significant assets and does not bear significant risks in respect of such transaction.

Starting from 1 January 2015, transactions with the same counterparty are considered as controlled transactions if the total amount of the group of transactions exceeds UAH 1 million (EUR 40,000) net of VAT, or 3% of the taxpayer’s annual taxable income, provided the total annual taxable income of the taxpayer and/or its related parties exceeds UAH 20 million (EUR 800,000).

The following transactions are not subject to TP:

- All other transactions except those listed above.
- Transactions in which prices are subject to state regulation.
- Transactions subject to mandatory valuation (if the TP methods cannot be applied).
- Transactions in which prices are determined by auction (if such auction is obligatory by law).
- Transactions on forced sale of collateral.

Related parties

The parties are considered related if (applies both to 2013/2014 and to 2015 onwards):

- direct and/or indirect ownership of one legal entity in another legal entity is no less than 20% including legal entities under the common ownership
- one legal entity, or an individual, has control of another legal entity through a single executive body including legal entities under the control of the same body
- one legal entity, or an individual, has control of another legal entity through the board of directors (right to appoint no less than 50% of the board) including legal entities under the control of the same body
- they are individuals: spouse (husband, wife), parents, children, brothers and sisters, trustees and children under guardianship, and
- an individual is related to other persons; such persons are considered related to each other.

Starting from 2015, in addition to the existing criteria for related parties, the following new criteria were introduced:

- A company is considered related to a company or an individual, if the latter lends or guarantees a loan, or provides financial aid to this company in the amount exceeding its equity by 3.5 times (10 times for financial institutions and leasing companies).
- The chain of legal entities is considered related if shares owned by each entity in the next legal entity in the chain exceed 20%.

Direct or indirect state participation in the legal entities does not make these entities related *per se*. Such entities can be recognised as related based on other criteria prescribed by the Tax Code.

On the basis of the facts and circumstances the tax authorities may prove in court that one legal entity or individual performed practical control over the business decisions of other legal entities and as a result, recognise such entities as related.

In addition, taxpayers may recognise themselves as related parties with their counterparties based on circumstances not explicitly prescribed by the Tax Code.

Transfer pricing methods

The TP rules provide five methods for determining the market price.

- Comparable uncontrolled price (CUP) method.
- Resale price method.
- Cost plus method.
- Net profit method.

- Profit split method.

The CUP method is the primary TP method to be used over all other methods. If this method is not relevant, the taxpayer is entitled to select the most appropriate method. This should be accepted by the tax authorities provided the selection of the method is justified.

Taxpayers are entitled to use a combination of two or more of the five methods. However, using methods or combinations of methods that are not prescribed in the Tax Code of Ukraine is not allowed.

The tax authorities should use the same method (combination of methods) used by the taxpayer, unless it is proven that the taxpayer selected an incorrect method.

According to changes to the TP rules from 1 January 2015 the list of methods is unchanged. The CUP method remains the priority method. However, if there is an equal reliability of the 'resale price' method or the 'cost plus' method as well as the net profit (margin) method or profit split method – the first two methods are given priority. Special rules for determination of market price for certain types of commodities traded with residents of low tax jurisdictions are excluded from the Tax Code of Ukraine.

The CUP method should be applied for cross-border transactions (with jurisdictions established by the CMU) with commodities quoted on the commodity exchange. The list of the commodity exchanges for each group of goods is to be established by the CMU.

For the abovementioned transactions, if the taxpayer uses a TP method other than the CUP method, such taxpayer is obligated to disclose to the tax authorities the profitability level of all related parties that participated in the sale-purchase chain of such goods (till the first non-related party).

For the purpose of applying the chosen TP method to a particular transaction, the taxpayer should compare the price or profit indicators in the controlled transaction with the price or profit indicators (the range of prices or profit indicators) in comparable uncontrolled transactions. If the price (profitability) in the controlled transaction is out of the arm's-length range, the median of the range should be used to assess the tax liabilities of the taxpayer. The tax authorities should use the same method (combination of methods) used by the taxpayer, unless it is proven that the taxpayer chose an incorrect method.

Comparability factors

The criteria of comparability are listed in the Tax Code of Ukraine. In particular, they include:

- the characteristics of the goods (works, services) that are the subject of the transaction
- the functions performed, risks assumed and assets employed by the parties of the controlled transaction (functional analysis)
- the existing practice of the relationship and the contract terms of the transaction that significantly influence the price
- the economic conditions including an analysis of the respective markets, and
- the business strategies of the parties of the controlled transaction.

Sources of information
For 2013 and 2014:

For TP control purposes, the tax authorities shall use the 'official sources of information' set by the CMU. In cases where there is an absence/lack of information in the official sources, the following sources of information can be used:

- prices of public auctions, tenders and exchange quotations
- statistical data from state authorities
- prices published in specialised commercial mass media (including internet media) including electronic and other databases, informational programmes and other public sources of information
- information about prices, interquartile range of prices/profitability and quotations published in mass media
- information from accounting and statistical reporting of taxpayers published in mass media
- results of independent valuation of property and property rights, and
- information about other 'controlled' transactions conducted by the taxpayer (this appears to be a mistake in the law which is expected to be corrected in the near future).

The tax authorities should use the same sources of information as those used by the taxpayer, unless it is proven that the taxpayer should have used other official sources of information.

For 2015 onwards:

Starting from 1 January 2015, the use of 'official sources of information' for TP purposes is no longer required. The following sources of information can be used:

- Information regarding comparable transactions of the taxpayer as well as its counterparty with non-related parties.
- Any publicly available sources of information which provide information on comparable transactions.

Transitional provisions (applicable only for 2013/2014)
The TP rules prescribe transitional provisions for 2013/2014 for cross-border transactions with residents of low-tax jurisdictions in respect of the prescribed types of commodities, which include agricultural, metal, iron ore and chemical products.

Taxpayers performing these transactions shall choose one of the following two options for the determination of prices for tax purposes:

- use the information about the prices on the stock exchange (for commodities traded on the stock exchange) or prices published in the official sources of information set by the CMU (for other commodities) and adhere to the permissible deviation percentage of up to 5%, or
- justify the prices by using one of the methods outlined above and disclose copies of the contracts for subsequent sales of commodities to unrelated parties.

Other regulations

There is a general tax consultation on the application of the new TP legislation issued by the Ministry of Revenues and Duties of Ukraine, which clarifies certain issues.

Documentation

All affected taxpayers should file a report (notification) on controlled transactions by 1 May of the year following the reporting year.

The TP documentation substantiating the market level of prices should be submitted only upon the request of the tax authorities.

Taxpayers should provide TP documentation upon the tax authority's request within one month. Transfer pricing documentation should include the following:

- Information about related parties.
- Information about the group including the legal structure, description of the activities, as well as the group's TP policy.
- Description and conditions of the transaction.
- Description of the goods (works, services).
- Terms and conditions of settlement.
- Factors that influenced the price determination.
- Information about functions performed, assets used and economic risks assumed by the parties of the controlled transaction.
- An economic analysis including a benchmarking study, substantiation of the TP method(s), amount of income (profit) and/or expenses related to the controlled transaction, its profitability, source of information used.
- A comparability analysis.
- Information about the proportional TP adjustment performed by the taxpayer (if any).

The request on provision of TP documentation can be sent to the taxpayer only after 1 May of the year following the calendar year in which the controlled transaction was performed.

If the prices of the controlled transaction do not correspond with the market level, the taxpayer performs the respective TP adjustment and pays the additional tax. The other party of the controlled transaction is entitled to perform a proportional TP adjustment after receiving the respective approval from the tax authorities. A proportional adjustment is also allowed in case of TP assessments by the tax authorities and based on the provisions of double tax treaties.

Starting from 2015 certain changes to the requirements for TP documentation and reporting have been introduced.

Taxpayers who performed controlled transactions during the reporting period should file an annex to the CPT return, which contains information about the performed controlled transactions. All taxpayers with controlled transactions with one counterparty exceeding UAH 5 million (approximately EUR 200,000), net of VAT, should file a report on controlled transactions by the first of May (each year) of the year following the reporting year.

All taxpayers performing controlled transactions should have TP documentation. The TP documentation should be submitted upon the request of the tax authorities within one month after receiving the request.

TP documentation should be prepared only in Ukrainian.

Penalties

The following penalties for non-compliance with the TP rules are:

- 100 minimum monthly salaries (the equivalent of UAH 121,800 [approximately EUR 4,900]) – for failure to file (or late filing) the report on controlled transactions.
- 3% of the controlled transaction value – for failure to file TP documentation (limited to 200 minimum salaries – UAH 243,600 [approximately EUR 9,800] – for all controlled transactions).
- 5% of the controlled transaction value – for the failure to declare the controlled transaction in the report on controlled transactions.
- up to 50% of the understated tax – if the tax was assessed by the tax authorities.
- 3–5% of the understated tax – in case of self-adjustment.
- a nominal penalty of the equivalent of UAH 1 (approximately EUR 0.04) for TP adjustment performed by the tax authorities for the period from 1 September 2013 till 31 December 2014. Penalties for non-filing a report on controlled transactions and/or TP documentation are still applicable for this period. No penalties are applied in case of self-assessed tax for the period from 1 September 2013 till 31 December 2014.

TP controversy and dispute resolution

TP audit

The TP rules introduce a specialised TP audit, which may be conducted in the following cases:

- Filing (or non-filing) of the TP report.
- Non-filing of TP documentation.
- Non-inclusion in the TP report of information regarding performed controlled transactions.
- Provision of the TP report and/or TP documentation with violations.
- Identification of a deviation of the prices in controlled transactions from the arm's-length level by the tax authorities.

The tax authorities cannot conduct more than one TP audit of each controlled transaction during one calendar year, although other (non-TP) tax audits may be conducted during this period. The statutory limitation period for TP assessments is 2,555 days.

The duration of a TP audit cannot exceed 18 months. Every six months during a TP audit the tax authorities should update the taxpayer on the status of the TP audit. The duration of the TP audit may be extended for an additional 12 months if information is to be received from foreign tax authorities or expert examination or translation has to be conducted.

The tax authorities are not allowed to examine pricing of controlled transactions during comprehensive full-scope tax audits. During the TP audit the tax authorities are entitled to interview employees of the taxpayer and/or its related parties.

Advance pricing agreements (APAs)
Large taxpayers are entitled to enter into APAs with the Ukrainian tax authorities. The subject of the APA may include:

- types and/or list of goods (works, services)
- prices of goods and/or list of methods for price determination
- sources of information used for price determination
- terms on which prices are agreed
- allowed deviation from commercial terms, and
- the conditions, terms of provision and the list of documents, which will confirm the taxpayer's adherence to the prices agreed upon in the APA.

Comparison with OECD Guidelines
Ukrainian TP rules are mainly based on OECD Guidelines; however, there are certain differences. The main differences include:

- the independence criterion, which is 20% in Ukraine
- controlled domestic transactions with related parties (applicable only for 2013/2014)
- controlled transactions with residents of jurisdictions, determined by the CMU, that are non-related
- transitional provisions (which are applicable only for 2013/2014) for cross-border transactions with residents of low-tax jurisdictions in respect of certain types of commodities (*see Transitional provisions section, above*), and
- special provisions for transactions with commodities, quoted on commodity exchanges, performed with residents of jurisdictions, determined by the CMU (applicable for 2015 onwards).

Ukraine

100.

United Arab Emirates

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Overview

The United Arab Emirates (UAE) currently does not have specific transfer pricing (TP) laws or guidelines. The UAE does not currently have a federal tax law. Instead, most of the Emirates constituting the UAE (including the Emirates of Dubai) have their own corporate tax decrees. In practice and with the exception of certain specific industries, the tax decrees have not been enforced to date and consequently tax is generally not actually levied on most companies operating in the UAE. If taxation were enforced, the decrees technically allow for taxes to be applied retroactively.

Country	**United Arab Emirates**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the Organisation for Economic Co-operation and Development (OECD) Guidelines?	Not applicable
Does TP legislation apply to cross-border inter-company transactions?	Not applicable
Does TP legislation apply to domestic inter-company transactions?	Not applicable
Does TP legislation adhere to the arm's-length principle?	Not applicable
TP documentation	
Can TP documentation provide penalty protection?	Not applicable
When must TP documentation be prepared?	Not applicable
Must TP documentation be prepared in the official/local language?	Not applicable
Are related-party transactions required to be disclosed on the tax return?	Not applicable
Penalties	
Are there fines for not complying with TP documentation requirements?	Not applicable
Do penalties or fines or both apply to branches of foreign companies?	Not applicable
How are penalties calculated?	Not applicable

United Arab Emirates

Introduction

The UAE does not currently have a federal tax law. Corporate income tax is only applicable to companies engaged in upstream oil and gas activities, and branches of foreign banks. Accordingly, there are no TP guidelines governing intragroup transactions in the UAE.

Legislation and guidance

There is currently no TP legislation and guidance in the UAE.

Penalties

There are currently no TP penalties in the UAE.

Documentation

There are currently no TP documentation requirements in the UAE.

Transfer pricing controversy and dispute resolution

There is currently no TP audit and dispute resolution process in the UAE.

Comparison with OECD Guidelines

There are currently no TP guidelines in the UAE.

101.

United Kingdom

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Overview

The United Kingdom's (UK's) transfer pricing (TP) rules, guidance and practice have remained relatively unchanged over the past year, although there has been a continuing focus on TP in the context of the ongoing international tax reform agenda and the Organisation for Economic Co-Operation and Development's (OECD's) action plan to counter base erosion and profit shifting (BEPS) in particular.

This was reflected in a Government position paper *Tackling aggressive tax planning in the global economy*, which emphasised the importance attached to BEPS by the UK Government and sets out the UK's position on each of the 15 action points set out in the BEPS' action plan.

Of particular interest from a TP perspective are the comments relating to:

- country-by-country reporting and TP documentation. The UK views this as an important initiative to enhance transparency between business and the tax authorities and has enacted legislation to enable formal country-by-country reporting requirements to be introduced into UK law, and
- alignment of TP outcomes with value creating activities. The UK considers that current TP rules allow an inappropriate level of profits to be attributed to low-tax jurisdictions by some multinational enterprises. The UK fully supports work to counter these activities including consideration of whether special measures should override the arm's-length principle in certain circumstances and this is expected to lead to further short and medium term changes in law and practice.

In addition, certain changes in UK anti-avoidance legislation have also been made recently, and these could have a significant effect for taxpayers. These include:

- A new diverted profits tax (DPT). DPT is a unilaterally implemented provision designed to target the diversion of profits from the United Kingdom through i) the artificial avoidance of UK permanent establishment status or ii) through entities or transactions which lack economic substance (as defined in the legislation). The result is a 25% levy on the diverted profits. DPT is effective from 1 April 2015 and does not contain an exemption for existing structures. Taxpayers are required to notify potentially affected structures to HMRC and the potential impact is significant (*see the New anti-avoidance provisions section for more information*).

- New anti-avoidance provisions applying where taxpayers are considered to have transferred part of their profits to a related party. The provisions are widely drafted and could affect certain TP arrangements (*see the New anti-avoidance provisions section for more information*).
- Changes to the UK's compensating adjustment rules for UK–UK transactions. These changes can impact individuals, partnerships and other non-corporates (*see the Self-assessment section for more information*).

These changes are discussed further below.

Country	**United Kingdom**
OECD member?	Yes
TP legislation	
Are there statutory TP documentation requirements in place?	No (Note 1)
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	By the filing date of the tax return
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	Proportion of the adjustment made to bring reported profits into line with an arm's-length result.

Note 1: the UK has not issued statutory documentation requirements. However, taxpayers are expected to retain suitable documentation to support their TP and penalties can apply where this requirement is not met (*see the Documentation section for more information*).

Introduction

Transfer pricing legislation in the UK is well established and the law requires that UK rules should be 'construed in such manner as best secures consistency' with the OECD Guidelines. In addition, the legislation is supported by a large amount of guidance material which has been published by Her Majesty's Revenue and Customs (HMRC). This guidance sets out HMRC's interpretation of the law and how it assesses TP risks. The guidance is publically available as part of HMRC's International Manual and is available via the HMRC website (https://www.gov.uk/government/organisations/hm-revenue-customs) (*see Other regulations and guidance section for more information*). In addition, the UK operates an advance pricing agreement (APA) regime and maintains a strong global treaty network.

The Transfer Pricing Group (TPG) was introduced in April 2008, and all enquiries are now subject to its governance and procedures (*see the Tax audits section for more information*).

Transfer pricing disputes in the UK are usually resolved by negotiation between HMRC and the taxpayer. Until recently, there was little case law, but in 2009 the tax tribunal found in favour of HMRC in DSG Retail and others v HMRC, the UK's first substantive TP case (*see the Legal cases section for more information*).

Legislation and guidance

Statutory rules

The UK's current TP rules – Taxation (International and Other Provisions) Act 2010 (TIOPA 2010), Part 4 – were enacted in February 2010 and took effect for all accounting periods ending on, or after, 1 April 2010. TIOPA 2010 represents a restatement of the previous rules which were contained in Schedule 28AA of ICTA (Income and Corporation Taxes Act) 1988 including later amendments, and which took effect for all accounting periods ending on, or after, 1 July 1999. TIOPA 2010 was part of the UK government's tax law rewrite project to update and consolidate a wider body of personal and corporate tax legislation.

The UK rules are widely drafted and are intended to cover almost every kind of transaction. Since 1 April 2004, the rules have applied to UK-to-UK transactions, and thin capitalisation rules have been brought wholly within the TP regime (*see the Thin capitalisation section for more information*).

Finance Act 2015 introduced new legislation to enable the introduction of country-by-country reporting requirements into UK law. Further legislation is expected to formally introduce other aspects of the OECD's BEPS action plan into UK law in the short to medium term.

Self-assessment

UK enterprises are required to self-assess their compliance with the arm's-length principle in filing tax returns. Where an enterprise would have lower taxable profits or greater allowable losses calculated on the basis of the actual provision for the transaction as shown in their accounting records than if calculated on the basis of the arm's-length provision, it is regarded as an 'advantaged person'. Such companies and partnerships must identify and make TP adjustments when submitting their tax returns under self-assessment. An important implication of this approach is the potential for interest and penalties for 'carelessness'. Penalties are discussed at Additional tax and penalties section, below.

The rules apply a 'one-way street' approach. Taxpayers are required to make TP adjustments where these result in increased taxable profits or reduced allowable losses in the UK, but are not permitted to make adjustments that result in decreased taxable profits or greater allowable losses. A decrease in the taxable profits or increase in allowable losses of the UK enterprise may be effected only through the operation of the competent authority procedures of the relevant double tax agreement (DTA) or, in the case of a UK-to-UK adjustment (*see below*), through a 'compensating adjustment'. This allows a 'disadvantaged person' involved in the transaction to calculate their tax on the same basis by making a 'compensating adjustment' to their taxable profits or losses. Such an adjustment can be made only by a disadvantaged person, and can be made only in respect of a transaction where a TP adjustment has been made by an advantaged person.

With effect from October 2013, the compensating adjustment rules were amended to prevent individuals from eliminating an income-tax liability through claiming a compensating adjustment. Where the new rules apply and a claim for a compensating adjustment is denied, the excess income is treated for income-tax purposes as a dividend, and taxed accordingly.

The participation condition

The legislation applies to transactions where the 'participation condition' is met. This is widely defined in the legislation, but generally means a transaction or series of transactions involving entities where one party controls the other, or both parties are under common control. The parties exerting control may include companies, partnerships and, in certain circumstances, individuals.

'Control' for the purposes of this legislation is defined in section 1124 of CTA (Corporate Tax Act) 2010 (formerly section 840 of ICTA 1988). It is important to note that control is not confined to situations where one party is the majority shareholder in the other. Effectively, control exists where one party has the power to ensure that the affairs of another party are conducted in accordance with the first party's wishes.

The concept of control set out in section 1124 of CTA 2010, is subject to important extensions for TP purposes under TIOPA 2010, Part 4 (and formerly Schedule 28AA of ICTA 1988):

- The rules apply to many joint venture companies where two parties each have an interest of at least 40%.
- Attribution rules are used to trace control relationships through a number of levels in determining whether parties are controlled for the purposes of the TP rules.

Further changes, known as the 'acting together' rules, affecting financing deductions, were made with effect from 4 March 2005. These changes were triggered by structures adopted by private equity houses but have wide-ranging effect beyond private equity (*see the Thin capitalisation section for more information*).

Concept of 'provision'

The legislation uses the concept of 'provision made by means of a transaction or a series of transactions' to describe the situations to which the legislation applies. Provision is undefined within the legislation, although it is understood that the use of the term is intended to allow the wider consideration of all the terms and conditions surrounding a transaction or series of transactions in deciding whether it has been conducted at arm's length. According to HMRC, 'provision' is broadly analogous to the phrase 'conditions made or imposed' in Article 9 of the OECD Model Tax Convention and embraces all the terms and conditions attaching to a transaction or series of transactions. While it might be argued that the term 'provision' is arguably wider than the phrase 'conditions made or imposed', HMRC takes the view that the scope of the UK legislation can be no wider than the scope of Article 9, as informed by the OECD Transfer Pricing Guidelines (OECD TP Guidelines).

In a recent tax case – DSG Retail and others v HMRC (TC00001) – the tribunal accepted a broad interpretation of the term 'provision', in line with Article 9 of the OECD Model Tax Convention, which refers to 'conditions made or imposed between two enterprises'. The court also accepted that a provision may exist where there is no formal or enforceable conditions (e.g. a contract), accepting that Schedule 28AA (the applicable legislation in the case), which refers to 'informal arrangements and understandings', applied (*see the Legal cases section for more information*).

OECD Guidelines

The legislation is drafted to explicitly require that the rules be 'construed in such manner as best secures consistency' between the domestic legislation and Article 9 of the OECD's Model Tax Convention and the OECD Guidelines. Legislation was passed in Finance Act 2011 (FA 2011) to update the definition of 'the TP guidelines' to refer to the revised OECD Guidelines, published in July 2010. As a result, from 1 April 2011, HMRC will use the 2010 OECD Guidelines in analysing a company's transfer prices (although the changes will influence HMRC's thinking for prior years as well, for example in the area of comparability).

It is anticipated that UK law will incorporate amendments to the OECD Guidelines through the BEPS action plan in due course, but it should be noted that this will not happen automatically and will require the legislation to be amended at an appropriate time.

Branches and permanent establishments (PEs)

TIOPA 2010, Part 4 (and formerly Schedule 28AA ICTA 1988) cannot be applied to dealings between a branch or PE, and the company of which it is a part, since the two are not separate legal entities. Instead, other sections of the legislation as well as the 'Business Profits' article of the relevant DTA operate to tax the appropriate amount of profit in the UK. In the case of an overseas' branch or PE of a UK company, the profits of the branch were taxed as part of the profits of the UK company, until the introduction of the exemption of foreign branches as part of the latest corporate tax reform programme. In the case of a UK branch or PE of an overseas' company, income arising directly or indirectly through or from the branch remains taxable in the UK under the Corporation Tax Act (CTA) 2009. The TP rules in TIOPA 2010, Part 4 can of course be applied to transactions involving related parties of the legal entity to which the branch or PE belongs. Hence, an overseas associated company of a UK company is also a related party in relation to an overseas branch or PE of that UK company, and TIOPA 2010, Part 4 could be applied to transactions between the two overseas enterprises.

Secondary adjustments

HMRC does not make secondary adjustments, such as deemed distributions or deemed capital contributions, when it makes a TP adjustment, as there is no basis in UK law for such adjustments.

Where the primary adjustment is made by a treaty partner, HMRC considers the merits of claims to deduct interest relating to the deeming of a constructive loan by a treaty partner following a TP adjustment. The claim would, however, be subject to the arm's-length principle and would be considered in the light of relevant provisions relating to payments of interest.

Where a treaty partner applies a secondary adjustment by deeming a distribution to have been made, this is now normally exempt from tax in the UK under the recently introduced dividend exemption rules. Any withholding tax (WHT) on the deemed dividend would likewise not be eligible for relief in the UK.

UK-to-UK transfer pricing

When it was originally enacted, Schedule 28AA of ICTA 1988 included an exemption for UK-to-UK transactions, subject to certain restrictions. With effect from 1 April 2004, the Government removed the exemption for UK-to-UK transactions from the TP legislation, primarily due to its concern that the existing rules might be held to be in breach of the Treaty of Rome, now the Treaty on the Functioning of the European Union (TFEU).

As there is no consolidated tax return in the UK, the UK-to-UK TP potentially has an impact where there is tax at stake, either because of particular tax planning arrangements or where some more routine aspect of the tax system (such as losses in one company in the group which cannot be offset) means that there is tax to be collected. One particular area where the amended rules have an effect is where no charge is currently made, for example, for services or for the use of assets (including intellectual property).

However, HMRC has no great desire to tie up resources investigating UK-to-UK transactions where the tax risk is low and experience of the level of such enquiries by HMRC since UK-to-UK rules were introduced generally supports this. Additionally, there is a corresponding adjustment mechanism to effect relief on the counter-side of a UK-to-UK transaction for which an adjustment has been assessed.

Concessions and exemptions

There are limited exemptions from the UK TP rules for small- and medium-sized enterprises (SMEs), where the definition of SMEs is assessed at a group level. Groups with more than 250 employees, turnover of over EUR 50 million or a balance-sheet worth of more than EUR 43 million do not qualify for the exemption, nor do SMEs entering into transactions with a tax-haven entity. Because denomination of these thresholds are in euros (as the definition of SMEs is a European Union [EU] one), exchange-rate movements may have an impact on a given SME group's qualification for exemption from the TP rules from one year to the next. The exemption does not apply where the enterprise has transactions with, or provisions which include, a related enterprise in a territory with which the UK does not have a double tax treaty (DTT) with an appropriate non-discrimination article. Such transactions remain subject to the UK's TP rules.

HMRC has also reserved the right to direct that the rules apply to medium-sized companies where it considers that TP has been manipulated egregiously.

Other regulations and guidance

HMRC manuals are prepared for internal use by the tax authority and are updated periodically. They are also publicly available including online versions accessible on the HMRC website. In general, these manuals provide a detailed description of how the tax authority interprets the existing legislation, and a rationale and explanation of its development. The International Manual contains guidance on the principles of double taxation relief, an introduction to DTAs and guidance on controlled foreign companies' (CFCs) legislation, guidance on TP, cross-border financing and thin capitalisation legislation, and practical advice to HMRC officials on conducting enquiries in these areas.

The TP sections of the International Manual were substantially rewritten in 2012 in order to make this guidance more clear, and to ensure that the manual was consistent in the messages that it gave. In terms of TP, the International Manual provides guidance on the factors HMRC should consider when applying the legislation, such as the circumstances indicating the presence of potential TP issues to address and matters to consider when deciding whether to pursue an enquiry and how enquiries are to be progressed through the TPG governance framework. The manual contains training and instructional material aimed at specialists in the TPG and at HMRC staff in local offices, who are part of the team dealing with TP enquiries. The practical guidance on TP covers the following main areas:

- Governance.
- Risk assessment.
- Working an enquiry.
- Examining TP reports.
- Gathering evidence.
- The interaction with direct taxes.

In addition, HMRC has issued statements of practice relating to APAs, advance thin capitalisation agreements (ATCAs) and mutual agreement procedures (MAPs). These statements also explain how HMRC interprets the relevant UK legislation and views its obligations under income-tax treaties and how it applies these in practice.

Thin capitalisation

Statutory rules

TIOPA 2010, Part 4 (and formerly, Schedule 28AA of ICTA 88) includes provisions that incorporate financial transactions. (Until 1 April 2004, thin capitalisation was generally dealt with separately from TP legislation.) Furthermore, general legislation enables HMRC to challenge the deductibility of interest paid by a UK company on a loan from a related party for which the interest rate is excessive or the amount of the loan itself is excessive. This domestic legislation compensates for the position existing under many older DTTs where there is an argument that the tax treaty does not provide the authority for the amount of the loan to be questioned. The measure for determining whether the amount of the loan or the interest rate is excessive is the arm's-length principle – that is, whether a third party would have loaned the company that amount of money or at that interest rate. The legislation seeks to align the UK position with Article 9 of the OECD Model Tax Convention.

The consequence of a successful challenge by HMRC is that any interest found to be excessive, by reference to the interest on the part of the loan found to be excessive or by reference to the rate of interest, is not allowed as a tax deduction.

There is no formal UK safe harbour debt-to-equity (D/E) ratio or acceptable interest cover. However, historically, it has often been suggested that a D/E ratio of 1:1 and interest cover of 3:1 could be considered to be 'safe'. HMRC had explained its tendency to accept these ratios on the basis that they reflect historical averages and that its resources are better used to examine cases with more extreme ratios.

However, more recently, HMRC has stressed that each case is examined individually and the acceptability of a ratio could well be influenced by the averages for the particular industry sector, and those may be different from those noted above. Other ratios are increasingly considered including the ratio of debt to earnings and other forms of interest cover. Other factors that HMRC would consider are factors that a third-party lender would consider, such as the consolidated D/E ratio of the borrower's group and the ability of the group to pay interest and repay capital. An acceptable ratio is, therefore, often a matter of negotiation.

HMRC provides clearance in many cases for loan arrangements, under the ATCA procedure, as described above in the Advance pricing agreements' section. This involves the provision of detailed documentation of the loan arrangements and valid projections of the taxpayer's interest cover or D/E ratio. Guidance is given in the International Manual. This guidance, which was significantly updated in a new version released in March 2010, shows how the basic pricing rule under self-assessment is more broadly formulated than the previous legislation. The guidance goes on to cover:

- Factors HMRC takes into account in determining whether interest is excessive.
- Cases where interest is not recharacterised.
- Circumstances where transactions should be considered together in order to evaluate compliance with the arm's-length principle.
- Outward investment and where such loans are interest-free or at a low rate of interest, and what factors may be taken into account in recharacterising such loans as equity.
- Interaction of the TP rules with the UK's legislation on foreign exchange and financial instruments.
- Treatment of funding transactions between UK charities and their affiliates.
- The use of third-party loan agreements as potentially comparable evidence of arm's-length borrowing.
- The acceptability of independent credit ratings and the use of company-produced credit ratings in pricing debt.

Acting together
Further provisions were introduced by the Finance (No. 2) Act 2005, which are incorporated in TIOPA 2010, Part 4 (and formerly Schedule 28AA of ICTA 88), related to the manner through which financing is effected. These provisions are particularly aimed at, but not limited to, private equity financing.

The changes restrict interest deductions to an arm's-length basis, where parties are acting together in relation to the financing of a company. The relevant provisions apply TP rules where persons who collectively control a company or a partnership have acted together in relation to the financing arrangements of that company or partnership.

Given the widely drawn provisions, a third-party bank could be drawn into the rules because it has agreed to provide finance for a deal, although such loans are accepted by HMRC as arm's length. There are clearance procedures for companies to obtain certainty with respect to their particular circumstances.

HMRC issued guidance on what constitutes acting together under TIOPA 2010, Part 4 (and formerly, Schedule 28AA of ICTA 88), which indicates that 'acting together' can be construed very widely.

Guarantee fees

TIOPA 2010, Part 4 (and formerly, Schedule 28AA of ICTA 1988) applies to a provision effected by one or more transactions. So, when a UK company borrows from a bank and the loan is guaranteed by its parent, there may be a provision between the parent and subsidiary. Between independent parties this would usually result in a fee from the borrower to the guarantor.

The rules provide that the borrowing capacity of a UK company must be considered without regard to the guarantee. In such a case (e.g. where the subsidiary is able to borrow more from a third-party bank because of a parental guarantee) there would be no deduction for the guarantee fee related to the excess borrowing, and there would be a potential disallowance of interest in excess of what would have been paid in the absence of the special relationship. This would apply even though the interest is paid to a third-party bank.

Where interest is disallowed for a UK borrower, an affiliated UK guarantor may be able to claim the deduction instead.

The value of a guarantee under the arm's-length principle depends on its terms. The arm's-length fee should be determined, based on what would be charged between independent parties under the same or similar circumstances. Where a UK parent provides a guarantee to overseas' subsidiaries, in some cases HMRC accepts that a guarantee may be equity in nature, especially where the borrower is thinly capitalised.

Thin Cap GLO

A recent case called into question the compatibility of the pre-2004 UK thin capitalisation legislation with the TFEU. The case, known as the Thin Cap GLO, was heard by the European Court of Justice (ECJ), which decided that the UK thin capitalisation legislation pre-2004 was a restriction on the freedom of establishment provisions of the TFEU. However, the ECJ referred the case back to the UK courts to decide the extent to which the thin capitalisation rules applied and therefore whether these represented a justifiable breach.

In late 2009, the UK court found that the pre-2004 legislation did represent a restriction on the freedom of establishment because the legislation did not include a 'commerciality' test (a separate test to the arm's-length test). It ruled that the pre-2004 legislation should not have applied to thin capitalisation cases where there was a commercial rationale for the transaction and that taxpayers were entitled to restitution for taxes paid as a result of the pre-2004 thin capitalisation legislation.

In February 2011, the UK Court of Appeal decided that the UK thin capitalisation legislation pre-2004 was European Commission (EC) Treaty-compliant. The decision took into account two later ECJ judgments – OyAA, C-231/05) in July 2007 and *Société de Gestion Industrielle* (C-311/08) – which the UK Court of Appeal took to mean the UK thin capitalisation legislation did not require an additional 'commercial purpose' test in order to be compliant with the EC Treaty. The decision was appealed to the UK Supreme Court, but they declined to hear the case, and it must now be considered closed.

Management services

The United Kingdom has enacted no specific legislation on management services and, consequently, where a business in the United Kingdom is paying for management services from a related party, the general rules on the deductibility of expenses applies. In general, the payment is tax-deductible where the business receives a benefit for the services provided and where the payment is connected with the business and is at an arm's-length price.

Where a UK business is providing services to related parties, it should be remunerated for those services on an arm's-length basis. This usually means that a profit element should be added to the cost of providing the service and invoiced to those businesses receiving the benefit of the services (i.e. a cost-plus basis) to represent a market value for the provision of the services. The arm's-length value of services can also sometimes be less than the cost of providing them. In such a situation the service should still be recharged at the market price (i.e. less than cost), and this principle is recognised in the OECD Guidelines.

Where services are recharged on a cost-plus basis, the amount of the mark-up is often the subject of negotiation with HMRC. There are no safe harbours in the United Kingdom, and no guidelines have been published as to standard acceptable rates of marking up costs in specified situations. HMRC has typically sought cost plus between 5% and 10% for low-value UK-provided services. It may well, however, look for a higher mark-up if it considers the services provided to be particularly valuable.

New anti-avoidance provisions

Diverted Profits Tax (DPT)

DPT is a new tax introduced by the UK and is charged at a rate of 25% on profits which are deemed to have been diverted away from a charge to UK tax.

DPT creates a liability in two scenarios:

- Where groups achieve a tax benefit by using transactions or entities which lack economic substance. In the context of DPT, economic substance is specifically defined in the legislation and includes consideration of the financial benefit of the transaction relative to the value of the tax reduction achieved;
- Where foreign companies have arranged their UK activities to avoid creating a UK permanent establishment.

Companies are required to notify HMRC of a potential liability to DPT and such disclosures may be required within 3 months of the end of the accounting period in which the potential liability arises. In addition, the legislation sets out specific time limits within which a preliminary notice can be issued by HMRC regarding assessment of a DPT charge. On receipt of a preliminary notice, a taxpayer will have 30 days to make written representations, which are limited to mechanical aspects of the application of the rules.

HMRC may then issue a charging notice assessing a DPT charge. Payment cannot be postponed and must be made by the taxpayer within 30 days, although an appeal can also be made within the same period. HMRC may subsequently assess additional DPT within 12 months of the initial payment, subject to further appeal by the taxpayer.

Certain exemptions apply, including cases where both parties are small or medium sized entities or where the transactions involve the receipt of payments by pension funds, sovereign immune bodies, certain investment funds or charities.

The impact of the new rules is expected to be significant for taxpayers with operations or structures affected by the rules and companies with concerns in this area should promptly review and consider the rules in more detail.

Transfer of corporate profits

New legislation has been announced to target avoidance schemes involving a transfer of corporate profits and applies where payments are made to transfer all (or a significant part of) the profits of a group company to a related party. The legislation is widely drafted and applies to restrict the tax deductibility of affected payments. Accordingly, a payment made on an arm's-length basis could, on a strict reading, nonetheless be non-deductible in certain situations. For example, the following situations could be affected:

- Profit split arrangements, where additional care may be needed in the wording of contracts and expressing how the profit split mechanism is intended to operate.
- In applying the transactional net margin method (TNMM), particularly where adjustments are made retrospectively or are made via journals at, or after, the year-end.

Companies with concerns over the new legislation should review its implications and application in more detail.

Penalties

Specific penalty provisions for TP have not been formulated and the general rules are to be applied. These general rules were considerably revised with effect for return periods beginning on, or after, 1 April 2009. For earlier periods, the previous legislation in Finance Act 1988 needs to be consulted.

For return periods ending on, or after, 1 April 2009, penalties may be levied for certain acts or omissions, depending on the offence. The penalties of most relevance to TP are for:

- Failure to notify chargeability to tax.
- Failure to provide information or documents under a formal notice to do so (*see the Information powers section for more information*).
- Filing an incorrect tax return.

Interest is normally charged on tax underpaid and is calculated from the day on which the tax was originally due.

There are two requirements for a penalty to be chargeable: i) a loss of tax or an increased claim to a loss or repayment; ii) the inaccuracy is careless, deliberate, or deliberate and concealed. There is no penalty if the inaccuracy occurs due to a mistake or despite taking reasonable care. In determining the level of the penalty in cases where losses are claimed, tax penalties apply in the same way as if there were additional tax. For returns relating to earlier periods, a penalty may be due if an incorrect return is fraudulently or negligently submitted.

Interest or penalties paid are not tax-deductible. In some cases the professional fees incurred in the course of the HMRC enquiry are also not tax-deductible.

One of the main concerns of business in relation to TP and penalties is what is meant by ‘carelessness’ (or ‘negligence’ under the previous rules), given that what is an arm’s-length price is a matter of judgment and there is not usually one ‘right’ answer. HMRC’s view is that where a taxpayer can show that it has made an honest and reasonable attempt to comply with the legislation, no penalty is imposed, even if there is an adjustment. Indeed, the onus is usually on HMRC to show that there has been a careless or deliberately careless inaccuracy by the taxpayer before a penalty can be charged.

While there is no legal definition of ‘carelessness’, taxpayers are obliged to do what a reasonable person would do to ensure that their returns are made in accordance with the arm’s-length principle. HMRC suggests that this would involve, but would not necessarily be limited to:

- Using their commercial knowledge and judgement to make arrangements and set prices that conform to the arm’s-length standard.
- Being able to show (e.g. by means of good quality documentation) that they made an honest and reasonable attempt to comply with the arm’s-length standard.
- Seeking professional help when they know they need it.

The emphasis is very clear that to avoid any suggestion of carelessness, the taxpayer must have set and documented a reasonable TP policy and must in practice implement and apply that policy correctly and consistently. HMRC has also made it clear that documentation does not in itself relieve a taxpayer from the possibility of a penalty if that documentation does not show that the business had good grounds for believing its arrangements and prices to be in accordance with the arm’s-length principle.

Range of penalties

The amount of the penalty that may be charged reflects the degree of culpability. Whereas there is no penalty for a mistake, failure to take reasonable care may incur a penalty of up to 30% of the potential lost tax revenue. If the inaccuracy is deliberate but not concealed, a maximum penalty of 70% may be charged, rising to a 100% penalty if the inaccuracy is deliberate and concealed. All penalties can be mitigated, depending on the quality of the disclosure.

Where an inaccuracy has resulted in an amount of tax being declared later than it should have been, the potential lost revenue is 5% of the delayed tax per year or part of a year.

These changes in the United Kingdom's penalty regime are expected to result in a significant increase in the number of penalties generally applied to companies. It remains to be seen what specific impact they will have on TP enquiries, where the incidence of penalties have previously been very low but there is an expectation that penalties are more likely to be seriously considered and applied by HMRC in future where a significant TP adjustment arises as a result of an audit.

Documentation

Notwithstanding the change in the burden of proof on TP with the introduction of self-assessment, unlike many other TP regimes, the United Kingdom has not issued specific regulations governing the documents that a taxpayer is required to prepare to support its TP. Instead, the United Kingdom has preferred to rely on the general rule for self-assessment that 'requires taxpayers to keep and preserve the records needed to make and deliver the correct and complete return', although it should be noted that the United Kingdom has not announced its approach to implementing the OECD's proposed approach for transfer pricing documentation under the BEPS action plan.

Historically, there has been some relaxation of HMRC's expectations on documentation in conjunction with the removal of the UK-to-UK exemption in 2004. In particular, while HMRC requires that there be evidence available to support arm's-length pricing at the time a tax return is submitted, the material recording of that evidence may be prepared and provided to HMRC in response to a specific request rather than as a matter of course. Failure to respond to such a request within a reasonable time exposes a company to the risk of penalties.

HMRC provides guidance in its International Manual on record-keeping requirements. HMRC specifies the following four classes of records or evidence that need to be considered:

- Primary accounting records – The records of transactions occurring in the course of the activities of a business that the business enters in its accounting system. These records are needed to produce accounts and the results (in terms of value) of the relevant transactions. In the context of TP rules, these are the actual results. They may or may not be arm's-length results and are generally created at the time the information entered the business accounting system.

- The tax adjustment records – The records that identify adjustments made by a business on account of tax rules in order to move from profits in accounts to taxable profits including the value of those adjustments. These adjustments might include the adjustment of actual results to arm's-length results, due to TP rules. These records do not need to be created at the same time as primary accounting records, but do need to be created before a tax return is submitted for the period in question.
- The records of transactions with associated businesses – The records in which a business identifies transactions to which TP rules apply.
- The evidence to demonstrate an arm's-length result – The evidence with which a business demonstrates that a result is an arm's-length result for the purpose of TP rules. This evidence needs to be made available to HMRC in response to a legitimate and reasonable request in relation to a tax return that has been submitted. Although the business would need to base relevant figures in its tax return on appropriate evidence, it is possible that, when the return is prepared, the material recording of that evidence may not exist in a form that could be made available to HMRC.

HMRC also quotes the discussion of documentation requirements in the current Chapter V of the OECD TP Guidelines that the demonstration of an arm's-length result should be "in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance".

To be able to support the view that the pricing method chosen results in arm's-length terms, it is often necessary to include in that documentation a study of third-party comparables, usually requiring a comparison with comparable third-party transactions, or with profitability earned by third parties. Without this, HMRC may regard any documentation as incomplete. To be satisfied that these comparables are truly comparable, or to evaluate the results obtained, it may well be necessary to carry out a detailed analysis of the risks and functions undertaken by a particular business.

Transfer pricing controversy and dispute resolution

Until recently, the few cases brought before the courts on TP issues in the UK had largely concerned procedural and interpretative issues rather than the substantive application of the rules. The early case law, such as Watson v Hornby (1942), Sharkey v Wernher (1955) and Petrotim Securities Ltd v Ayres (1963), established the principle of arm's-length prices for transactions between related parties as now embodied in the legislation. Two more recent cases are of importance in the interpretation and application of the legislation which preceded Schedule 28AA of ICTA 1988.

Ametalco UK v IR Commrs (1996)

The facts of Ametalco concerned the nature of the transactions to which the TP legislation could be applied. The UK company had, at the request of its parent, advanced an interest-free loan to a related company. Under the provisions of sections 770 to 773 of ICTA 1988, the tax authority claimed the right to impute notional interest on the loan and tax the consequent notional income in the hands of the UK lending company.

The Revenue maintained that the legislation applied to all types of transaction including loans or advances of money and, in its view, this type of transaction was covered by section 773 of ICTA 1988 as a business facility of whatever kind. Various arguments to refute this position were advanced by the taxpayer, but these were rejected by the Special Commissioners, who decided in favour of the Revenue.

This case was important in relation to the old legislation, since it clarified the position regarding the applicability of the legislation to loans and interest in general, and interest-free loans in particular.

Glaxo Group Ltd v IR Commrs (1995)
In Glaxo Group Ltd, several companies in the Glaxo Group had many years of open (unagreed) assessments as a result of unresolved appeals. The Revenue suspected that the companies had been engaged in transactions with related parties on a non-arm's-length basis and sought to increase the open assessments to reflect TP adjustments.

Glaxo contended that TP adjustments had to be effected by raising new assessments and not by amending existing open assessments. There was then a six-year time limit on new assessments (except in cases involving fraud or negligence) and this would have limited the adjustments the Revenue could make. It was held by the Special Commissioners that TP adjustments could be made to the open assessments.

Special Commissioners decision – Waterloo plc and other v IR Commrs (2001)
In this case, the Special Commissioners considered the TP rules in connection with the costs associated with the operation of international share plans by Waterloo plc (the name of the company was made anonymous in the published judgment). The Special Commissioners held that Waterloo plc should be taxed as if it had charged a fee to its overseas' subsidiaries for providing share benefits to their employees, and that an upward adjustment to Waterloo's taxable profits should be made under the TP rules.

The Special Commissioners decided that providing the ability for the employees of the subsidiaries to participate in the option arrangements was a 'business facility'. The Special Commissioners accepted that the options were remuneration for the employees. The parent company therefore provided some of the remuneration of employees of the subsidiaries, by means of the totality of the arrangements. Provision of remuneration to the subsidiaries was the valuable business facility in question.

The business facility was made directly to the subsidiaries employing the individuals who participated in the option arrangements. Section 770 of ICTA 1988 as amended by section 773(4) required a 'giving' of facilities to a recipient – not a clear transaction with a sale and a purchaser – therefore, there was no need to identify a transaction directly between the parent and the subsidiary. The Special Commissioners decided that there was a clear, valuable benefit from the share scheme to the subsidiary employing the relevant employees, and the value of that benefit was capable of being calculated. On a wider level, the case provides a presumption that section 773(4) of ICTA 1988 allowed the Revenue to tax the total facility provided intragroup and did not require a transaction-by-transaction analysis: "the phrase 'business facility' is a commercial not a legal term, and … that where a commercial term is used in legislation, the test of ordinary business might require an aggregation of transactions which transcended their juristic individuality" (paragraph 57 of the published decision).

Following this reasoning, Waterloo plc failed in its argument that section 770 of ICTA 1988 did not apply because the transactions took place between persons not under common control (i.e. the share scheme trustee and Waterloo plc).

The Revenue issued guidance on its view of this case and, subsequently, on the application of the arm's-length principle to share plans in light of the accounting rules for share-based payments under International Financial Reporting Standard (IFRS), which apply to accounting periods beginning on, or after, 1 January 2005.

In addition to these court cases, appeals on TP – which are now heard in the first instance by the tax tribunals rather than the Special Commissioners – create a rebuttable presumption on the interpretation of the legislation and can establish the facts of a case and the TP methodologies that should be applied.

Tax tribunal decision – DSG Retail and others v HMRC (TC 00001) (2009)
This case was the first UK litigation in which issues of TP methodologies and the application of the OECD TP Guidelines was heard in detail.

This is widely known as the Dixons' case because it concerns the sale of extended warranties to third-party customers of Dixons, a large retail chain in the United Kingdom selling white goods and home electrical products. The DSG group captive (re)insurer in the Isle of Man (DISL) insured these extended warranties for DSG's UK customers. Until 1997, this was structured via a third-party insurer (Cornhill), which reinsured 95% on to DISL. From 1997 onwards the warranties were offered as service contracts that were 100% insured by DISL. The dispute concerned the level of sales' commissions and profit commissions received by DSG.

The First-tier Tribunal (Tax) rejected the taxpayer's contentions that the TP legislation did not apply to the particular series of transactions (under section 770 and Schedule 28AA of ICTA 88) – essentially the phrases 'facility' (section 770) and 'provision' (Schedule 28AA) were interpreted broadly so that there was something to price between DSG and DISL, despite the insertion of a third party and the absence of a recognised transaction between DSG and the other parties involved.

The Tribunal also rejected potentially comparable contracts that the taxpayer had used to benchmark sales' commissions on similar contracts on the basis that the commission rate depended on profitability, which itself depended on the different level of loss ratios expected in relation to the products covered. A much more robust-looking comparable provider of extended warranty cover offered as a benchmark for the market return on capital of DISL was also rejected, owing to its differing relative bargaining power, compared to DISL. This third-party reinsurer was considered to be a powerful brand providing extended 'off-the-shelf' warranty cover through disparate distributors – the Tribunal noted that DSG had a strong brand, powerful point of sales advantage through access to customers in their shops and could easily have sourced the basic insurance provided by DISL, elsewhere.

The overall finding of the Tribunal was that, to the extent that 'super profits' were available, these should be distributed between the parties according to the ability of each party to protect itself from normal competitive forces and each party's bargaining power. The Tribunal noted in this context that DISL was entirely reliant on DSG for its business. According to the facts of this case, the super profits were deemed to arise because of DSG's point-of-sale advantage as the largest retailer of domestic electrical goods in the United Kingdom and also DSG's past claims' data. DISL was considered to possess only routine actuarial know-how and adequate capital, both of which DSG could find for itself.

As a result, the Tribunal thought that a profit-split approach was the most appropriate, whereby DISL was entitled to a market return on capital, with residual profit over and above this amount being returned to DSG via a profit commission.

This decision is important in understanding HMRC's approach to TP and to future litigation in this area. It offers valuable insights into consideration of:

- The level of comparability demanded to support the use of comparable uncontrolled prices (CUPs).
- Selection of the appropriate 'tested party' in seeking to benchmark a transaction.
- The importance of bargaining power.
- The Tribunal's acceptance and approval of profit split as the most appropriate methodology.
- HMRC's expectation that a captive insurer that is underwriting 'simple' risks, particularly where the loss ratios are relatively stable and predictable, and that does not possess significant intangibles or other negotiating power, should not expect to earn more than a market return to its economic capital.

It is debatable whether this success in the Tribunal will encourage HMRC to take more TP cases to litigation. Litigation is a costly process for both sides, and subsequent cases may not go as well as this case did for HMRC. At present, there does not appear to be a pipeline of TP cases in the United Kingdom awaiting litigation; indeed, all the indications are that HMRC will be keener to resolve disputes with taxpayers on a more collaborative basis and will be more inclined to take cases to facilitative mediation rather than litigation (*see the Anticipated developments in law and practice section for more information*).

Burden of proof

Under the United Kingdom's current legislation, the burden of proving that transfer prices are at arm's length falls on the taxpayer. The act of submitting the return under self-assessment implicitly assumes that the taxpayer has made all necessary adjustments to taxable profits to take account of non-arm's-length pricing.

Where HMRC considers there has been tax revenue lost as a result of negligence or carelessness (for accounting periods ending on, or after, 1 April 2009), the burden of proving that this was a result of the taxpayer's negligence or carelessness, rather than for the reasons given by the taxpayer, falls on HMRC.

Tax audits

Under self-assessment, a company submits a corporation tax return and its statutory accounts, with a due date for submission normally within 12 months after the end of the accounting period to which the return relates. HMRC may commence an enquiry into the return by issuing a formal notice by the local tax inspector with responsibility for the company, within specified time limits. Once an enquiry has been initiated, the scope may extend to anything covered in the tax return including TP. HMRC is not obliged to state reasons for initiating an enquiry.

Transfer pricing enquiry governance and management

In 2008, HMRC revised its practices and procedures through the introduction of the Transfer Pricing Group (TPG), largely to achieve the objectives set out in the Varney Report on Links with Large Business. Specifically, HMRC aims to provide greater certainty, an efficient risk-based approach to dealing with tax matters, a speedy resolution of issues and greater clarity through effective consultation and dialogue.

In specific relation to TP, HMRC stated that it aims to conclude most enquiries within 18 months, with only the most high-risk and complex cases taking 36 months. The introduction of the TPG and its governance framework together with resources available to the TP teams dealing with enquiries is intended to enable HMRC to deliver this objective.

Transfer pricing team

Working enquiries on a team basis marks a significant change from HMRC's previous approach to TP. The size and make-up of a TP team is dependent on the scale and complexity of the enquiry. The team is usually led by the HMRC customer relationship manager (CRM) of the business and consists of other members of the case team working for the CRM as well as members from various disciplines including at least one TP specialist from the TPG.

HMRC has recently undergone a reorganisation and the TPG now consists of dedicated TP specialists based in the Large Business Directorate, with some support expected to be allocated to the Mid-Size and Small business teams. HMRC also employs other specialists, such as economists, systems analysts and specialist investigators. The role of the TP specialist is to support the team as appropriate, from providing specialist advice to hands-on involvement.

Practices and procedures

When the TPG was set up, each enquiry or potential enquiry to which the TP governance applied was subject to a process involving five stage gates consisting of the business case, enquiry decision, action plan, six monthly review and resolution review. HMRC has since streamlined this approach into three stages. These stages aim to provide a structured and consistent approach in relation to the management and governance of enquiries.

The three stages of TP Governance are:

1. Making sure the selection of a case is appropriate.
2. Ensuring there is effective progress in a case.
3. Reaching the appropriate conclusion in a case

HMRC has stated that all three aspects are essential to the process and all are mandatory for HMRC case officers. Therefore, the selection stage will require that a business case is made, and approved, before an enquiry is commenced. The second progress stage brings together the former action plan requirement and the progress review requirement into one ongoing review process, which is linked, where appropriate, through a new template to existing casework control mechanisms in place within HMRC. The resolution phase is unchanged from the old stage gate five in requiring approval for any settlement proposals.

Triggers for a transfer pricing enquiry
HMRC identified the following risk areas that are most likely to trigger a full TP enquiry:

- The existence of tax haven entities – HMRC identifies groups with entities located in tax havens and seeks to establish whether their profitability is commensurate with the level of functions, assets and risks relating to these entities. For example, limited functions undertaken by entities located in tax havens that enjoy healthy profits may give rise to a TP enquiry.
- Lower returns in the United Kingdom than in the group generally – HMRC identifies businesses with profit margins that are lower in the United Kingdom than in the group generally and seeks to establish why this is the case.
- The UK business produces only a routine, low-margin profit – HMRC identifies companies that possess the resources to generate high-margin profits, yet produce only a routine, low-margin profit. To understand the potential profitability of a particular entity, HMRC is interested in whether there is, for example, heavy investment in the entity, a highly skilled and remunerated technical or R&D (research and development) workforce or intangibles (e.g. trade names, know-how, patents).
- Royalty or management fee payments from the UK business that do not appear to make commercial sense and which substantially impact on the UK profits. Examples of such payments:
    - A brand name unknown in the UK.
    - Technology to which significant value has been added by processes carried out in the UK.
    - Nebulous bundles of intangibles.
- Poor performance over a number of years. Persistent losses attract the attention of HMRC, and HMRC looks for evidence that there is a clear prospect of a return to profits in later years to justify the risk of continuing losses.
- Changes in the risk profile and hence the reward of the UK business. Examples of this include:
    - Distributor becomes commissionaire (and net profits decrease).
    - Full manufacturer becomes contract manufacturer.
    - R&D activities that once generated royalties move to contract basis.
    - Cost-sharing arrangements are introduced.

HMRC concedes that consideration should be given to both the potential tax at risk and the level of difficulty in establishing the arm's-length price, although there is no *de minimis* limit in the UK's TP legislation.

The International Manual provides further detailed practical guidance and examples of HMRC's approach and interpretation of TP principles.

Information powers

Changes to HMRC's general information powers were introduced with effect from 1 April 2009. HMRC can require any person to provide them with information or to produce documents by way of a written notice. It must allow the person a reasonable period of time to produce the information or documents. The person receiving the information notice may appeal against it, unless the notice is to produce the statutory records that the person is obliged to keep or if the tax tribunal approved the issue of the notice.

Penalties may arise for failing to comply with an information notice, or concealing, destroying or otherwise disposing of documents, or providing inaccurate information, or a document containing an inaccuracy, in response to an information notice.

If the taxpayer does not provide information in response to HMRC's requests, where considered necessary, HMRC may enter a company's premises and inspect the premises, assets and documents on those premises that relate to TP issues under enquiry. HMRC cannot search premises, nor search for assets or documents. Normally, HMRC must give the occupier of the premises at least seven days' notice of an inspection. An unannounced or short-notice inspection is possible, but this must be agreed by an authorised HMRC officer or approved by the tax tribunal.

HMRC also has powers enabling it to obtain information from third parties where it considers such information would be helpful in progressing enquiries. However, such powers are used rarely and only in extreme circumstances, since these powers are viewed by the HMRC itself as controversial and requiring sensitive handling. Failure to provide information as requested is more likely to result in an estimated assessment being raised, for which the company must then provide the evidence to refute it.

HMRC does not have the power to directly obtain information on non-UK-resident parents of UK companies, nor on fellow subsidiaries (in non-UK-controlled groups) that are not UK-resident. Note, however, that the United Kingdom has an extensive DTT network and, as a result, is able to request such information under the Exchange of Information article. HMRC also increasingly uses the provisions of the EU Mutual Assistance Directive that provides for Member States to exchange information on taxpayers and embark on 'simultaneous controls' where the tax position of a taxpayer and related entities are of interest to more than one Member State (*see the Joint investigations section for more information*).

Revised assessments and the appeals' procedure

Where there is an open enquiry or HMRC has issued a closure notice, amended the taxpayer's return, or made a 'discovery' assessment, the taxpayer may ask for the case to be listed for hearing by the tax tribunal. Alternatively, the taxpayer may require HMRC to review the point at issue, or HMRC may offer the taxpayer a review (section 49A of the Tax Management Act [TMA] 1970). If a review takes place, HMRC may uphold, vary or cancel its original view of the matter, and must notify the taxpayer of its conclusion within the following 45 days, or other agreed period (section 49E of the TMA 1970). If HMRC's review is unfavourable and the taxpayer does not wish to accept it, the taxpayer must file an appeal to the tax tribunal within 30 days; otherwise, HMRC's review conclusions are treated as having been agreed.

The tax tribunal has also made it clear that it will expect parties to disputes involving complex facts such as TP to have sought an internal review or considered other forms of dispute resolution, such as facilitative mediation using an independent mediator, before such cases are brought before the tribunal.

The taxpayer or HMRC may appeal against a decision of the First-tier Tribunal (Tax) on a point of law (but not a question of fact). This appeal is normally then heard by the Upper Tribunal (Tax and Chancery) and from there to the Court of Appeal and, possibly, the UK Supreme Court, although few tax cases are heard by this Court. If a question of European law is involved, any of these courts can refer the case to the European Court in Luxembourg.

Resources available to the tax authorities

The key resource for TP enquiries is the TPG (*see the Tax audits section for more information*). Within the TPG, a centralised specialist TP unit, which is part of HMRC's Corporate Tax, International and Anti-Avoidance (CTIAA) directorate, has responsibility for the policy on TP and technical aspects of the legislation. It has traditionally been involved in the TP enquiries into large multinational groups, as well as housing the mutual agreement procedure (MAP) and the advance pricing agreement (APA) programme management.

Use and availability of information on comparables

HMRC has widely adopted the principles in the OECD Guidelines including the revisions made in 2010 and, therefore, closely follows the OECD guidance on comparability. Information on comparables plays a crucial element in defending TP policies in the United Kingdom.

All UK companies – public and private – are required to prepare statutory accounts and file these with the Registrar of Companies at Companies House. Certain companies, such as small- or medium-sized companies, need to provide only abbreviated accounts with a limited amount of detail. Copies of these accounts are publicly available, but their usefulness may be limited by the amount of detail given.

HMRC has access to its own sources of comparable data and also uses commercially available databases of company results. These contain a summary of each company's financial results for several years, hence facilitating access to potentially comparable information. In practice, HMRC also generally accepts pan-European searches based on European company data.

HMRC and company advisers are bound by confidentiality considerations in respect of information obtained through work on other companies for the purposes of disclosure to third parties. In reality, both parties accrue considerable expertise and knowledge through the consideration of relevant issues, which can be used in future enquiries. However, HMRC does not overtly use 'secret comparables' to challenge taxpayer prices, although it might use them in selecting cases for enquiry.

Risk transactions or industries
No transactions or industries are excluded from the scope of TP legislation. If a particular industry or issue has come to the attention of the TPG, HMRC is likely to use the information and experience gained in dealing with one taxpayer in enquiries into other similar taxpayers. Within the TPG, there is increasing specialisation in certain industry sectors, such as financial services, automotive, consumer goods and pharmaceuticals. Oil and gas cases are also dealt with by specialists within the Oil & Gas Sector of HMRC's Large Business Service (LBS). The LBS has also established industry specialists within a number of offices to focus on particular sectors.

In short, all transactions and industries are at risk of a TP enquiry in the United Kingdom. There has been a tendency in the past for queries to be raised, not in connection with specific industries, but in respect of certain inter-company transactions. In particular, focus was given to TP related to interest, royalties and management fees, rather than the TP of goods and services. However, this is changing with more experience and the specialist approach introduced by the TPG. The risk-based approach to enquiries explained at Tax audits section should now inform the focus of most HMRC enquiries.

More recently, HMRC is showing particular interest in the TP of debt as its experience on this topic has increased significantly with the ATCA programme.

Limitation of double taxation and competent authority proceedings
In connection with the operation of the MAP, the following points should be noted:

- The designated competent authority in the CTIAA directorate deals with cases presented under the MAP in respect of TP; HMRC may provide a unilateral solution to instances of economic double taxation, or consult under the MAP to try to reach agreement with the other tax authority in a way that eliminates the double taxation.
- There is no guarantee that a corresponding adjustment will be made, since the two tax authorities are not required to reach a resolution under the MAP, although an increasing number of the United Kingdom's DTTs now include an arbitration clause and for EU-related adjustments, arbitration is available under the European Arbitration Convention (*see below*).
- If a UK company is considering seeking a corresponding adjustment as a result of an adjustment by an overseas' tax authority, a protective claim should be made as soon as possible to avoid a situation where the time limit for a corresponding adjustment has expired.
- The provisions of sections 124 and 125 of TIOPA 2010 (formerly, section 815AA of ICTA 1988) clarify the time limits applicable to the MAP. In the absence of a specific time limit in a treaty, a time limit of six years from the end of the accounting period to which the adjustment relates applies for making claims in respect of cases presented to the UK competent authority.
- Sections 124 and 125 of TIOPA 2010 explain how an agreement reached under the MAP is put into effect in the United Kingdom. The UK legislation also enables consequential claims to be made within 12 months of the notification of a solution or mutual agreement. This allows, for instance, additional loss-relief claims to be made, even though the normal time limits for a loss claim may have expired.
- There is no formal method of making a case under the MAP in the United Kingdom. The taxpayer should simply apply in writing, stating the details of its case including the years concerned, the nature of the case and details of the parties involved.

It is worth noting that some competent authority procedures may take several years to complete, with no guarantee of a satisfactory outcome. However, regular meetings between HMRC and certain other tax authorities where the competent authority cases are likely to be most numerous, such as the Internal Revenue Service (US), the NTA (Japan) and the SLF/DGI (France), help considerably to resolve MAP cases.

HMRC has traditionally taken a robust line in relation to engaging in MAP discussions before a TP adjustment has been made in the United Kingdom. This is in contrast to many other tax authorities that allow MAP proceedings to commence before an adjustment is finalised. However, HMRC has recently issued a Statement of Practice (SoP) on MAPs which has marked a softening of this line by suggesting that HMRC may now be willing to take part in MAP discussions before a TP enquiry is concluded in particular circumstances. Nonetheless, the MAP is not seen by HMRC as an alternative to the normal enquiry process.

Arbitration

As a Member State of the EU, the United Kingdom has signed up to the arbitration procedures of the EU Arbitration Convention. The Convention provides that where the tax authorities concerned cannot resolve differences through a MAP within two years, they will be subject to mandatory arbitration procedures, if the taxpayers concerned wish to proceed to arbitration. The arbitration procedure consists of an advisory commission including independent experts who give an opinion within a specified timescale. Both tax authorities must act on this opinion or agree within six months on another course of action that resolves in full, the double taxation.

The benefit of the Convention is that it should ensure that the competent authorities resolve cases fully within a specified timescale of two years. While an increasing number of claims are being made under the Convention, very few cases have gone forward to arbitration, although a large number of claims are now, in theory, approaching the time limit.

The United Kingdom has also included arbitration provisions in its most recent DTTs, such as those signed with France, Germany and the Netherlands. The method of arbitration to be used is not specified and will presumably be determined on a case-by-case basis.

Advance pricing agreements (APA)

The United Kingdom has had formal APA procedures since 1999. Before 1999, APAs were possible, only by means of an agreement under a DTT. A recently updated Statement of Practice 2/10 (the Statement) provides guidance on HMRC's interpretation of TIOPA 2010, Part 5 (formerly sections 85 to 87 of Finance Act 1999). This legislation allows for APAs and establishes the APA procedures. In the new Statement, which supersedes SP 3/99, HMRC explains how it applies the legislation in practice. The revised Statement has resulted in two significant changes in HMRC's approach, by relaxing the 'complexity' threshold for accepting APA applications and encouraging more unilateral APAs.

Applicants and scope

A UK business may request an APA in respect of transactions that are subject to TIOPA 2010, Part 4 (formerly, Schedule 28AA of ICTA1988). APAs may also be requested by non-residents trading in the United Kingdom through a PE or branch, and by UK residents trading through branches or PEs outside the United Kingdom. No fee is payable in the United Kingdom for an APA.

APAs may involve TP methods covering different types of related-party transactions, or only for particular types of transactions, as well as other intragroup arrangements including transfers of tangible or intangible property and the provision of services. APAs may relate to all the TP issues of the business, or be limited to one or more specific issues.

Historically, HMRC expressed its preference for including the tax authority of the related party in the discussions and concluding a bilateral APA. However, in the new Statement it recognises that unilateral APAs may be agreed in certain circumstances, such as where the other side of the transaction does not have a formal APA programme, or where the conclusion of a bilateral agreement would provide little additional benefit to either party.

Process

Section 218(1) of TIOPA 2010 (formerly section 85(1)(c) of Finance Act 1999) provides that the APA process is initiated by a business making an application for clarification by agreement regarding the application of the statutory provisions. The APA process typically comprises four stages: an expression of interest, the formal submission of application, evaluation of the proposed methodology and critical assumptions and, finally, drawing up the agreement.

At the expression of interest stage, or at the stage when a formal proposal is submitted, HMRC may exercise its discretion by declining the request for an APA. In that event, HMRC advises the business of the reasons for doing so, and allows the business the opportunity to make further representations. A business may withdraw an APA request at any time before final agreement is reached.

HMRC has stated that it anticipates that all proposals will need to be supported by most of the following information:

- The identification of the parties and their historic financial data (generally for the previous three years).
- A description of the TP issues proposed to be covered by the APA and analysis of the functions and risks of the parties, and projected financial data of the parties in relation to the issues.
- A description of the worldwide organisational structure, ownership and business operations of the group to which the taxpayer belongs.
- A description of the records that will be maintained to support the TP method proposed for adoption in the APA.
- A description of current tax enquiries or competent authority claims that are relevant to the issues covered by the proposed APA.
- The chargeable periods to be covered by the APA.
- The identification of assumptions made in developing the proposed TP method that are critical to the reliability of its application.
- A request for a bilateral APA.

- If applicable, representations from the business that HMRC should exercise its discretion in exchanging information, where the business considers such information to be trade secrets.

Information supplied by a business in relation to an APA contributes to the pool of information held by HMRC about that business. HMRC explicitly states that the information may be used for purposes other than evaluating the APA request. In addition, HMRC has suggested they may now be more likely to share information on unilateral APAs with the appropriate treaty partners that may be impacted.

Nature and term
An executed agreement between the business and HMRC determines the treatment of the TP issues for a specified period of time. The terms of a bilateral APA also reflect the agreement reached between the two tax authorities. If HMRC does not reach an agreement with the business, HMRC issues a formal statement stating the reasons.

APAs usually operate prospectively, relating to the accounting periods beginning after the application is made, although HMRC does allow 'rollback' of APAs in certain circumstances, which can sometimes be very helpful in resolving existing TP disputes. HMRC expects most APAs to be for a maximum term of five years.

HMRC considers that APA information is subject to the same rules of confidentiality as any other information about taxpayers and that the unauthorised disclosure, even of the existence of an APA, is a breach of that confidentiality.

APA monitoring and renewal
The APA identifies the nature of the reports that the business is required to provide under the APA legislation. The agreement also provides for the timing of the submission of these reports, which is typically required annually, coinciding with the filing date for the tax return.

The annual report addresses whether the agreed-upon method was applied during the year, the financial results produced by the method, and whether there was a mismatch between prices actually charged and those obtained by applying the arm's-length standard under the agreed methodology. The business also must provide details of compensating adjustments made, and an assessment of the continued applicability or otherwise of the critical assumptions used in the APA.

HMRC has the power to nullify an APA when the business has fraudulently or negligently provided false or misleading information regarding the APA application. When considering using this power, HMRC takes into account the extent to which the terms of the APA would have been different in the absence of the misrepresentation.

An APA may provide for modification of its terms in specific circumstances. For example, an agreement may provide that when there has been a change that makes the agreed methodology difficult to apply but that does not invalidate a critical assumption, the agreement may be modified with the consent of the parties. Additionally, APAs now include a specific clause providing for revisions to the terms of the agreement if they are not consistent with the final output of the OECD's BEPS action plan.

A business may request the renewal of an APA. The request should preferably be made no later than six months before the expiration of the APA's current term. However, HMRC usually accepts requests made before the end of the first chargeable period affected by the renewal. If the TP issues have changed, or a different method is being proposed, the business must make a new APA application.

Penalties and appeals

A tax-geared penalty is imposed when a business has acted carelessly in making an incorrect return and tax has been lost as a result. When a return is made in accordance with an APA, and false or misleading information was submitted carelessly in the course of obtaining the APA, the agreement is treated as if it had never been made. The business has the right to appeal against the amount of additions to profits arising as a result of the revocation or cancellation of an APA.

Advance thin capitalisation agreements

In 2007, HMRC introduced the advance thin capitalisation agreement (ATCA) to provide certainty to financing transactions. These are unilateral APAs and are based on the same statutory provisions as the normal APA. The process is designed to offer assistance in resolving TP issues in relation to financing transactions that, for any particular period, have a significant commercial impact on an enterprise's profit or losses.

ATCAs may cover the treatment of a single applicant's financial instrument, or the treatment of the overall debt position of a group, depending on circumstances. HMRC issued guidance in relation to which situations are suitable for ATCAs in a SoP 04/07. This guidance states that situations suitable for ATCAs include, but are not limited to, the following:

- Intragroup funding outside the scope of treaty applications (e.g. involving a quoted eurobond or discounted bond).
- Financing arrangements brought into TIOPA Part 4 (formerly, Schedule 28AA of ICTA 1988 by the 'acting together' rules [*see Statutory rules, above*]).
- Financing arrangements previously dealt with under the 'treaty route' (i.e. as part of a claim made by the recipient of the interest to benefit from reduced rates of WHT under the provisions of a DTT).

While the ATCA normally applies prospectively in relation to accounting periods beginning after the application is made, it is possible that an ATCA may be applied retrospectively or rolled back as an appropriate means for amending a self-assessment return, or resolving outstanding TP issues in earlier years.

Anticipated developments in law and practice

One development is HMRC seeking to make more use of collaborative dispute resolution tools to resolve long-running and difficult TP enquiries as an alternative to litigation. Facilitative mediation is being explored, but it is likely to be used only in a small number of cases.

There are also indications that HMRC is becoming more involved in joint audits with other tax authorities as part of greater collaboration and cooperation between tax authorities, which has been endorsed by the OECD's Forum on Tax Administration (*see the Joint investigations section for more information*).

Liaison with customs' authorities

In April 2005, the UK government integrated the Inland Revenue and HM Customs & Excise into a single department (Her Majesty's Revenue & Customs [HMRC]). The Inland Revenue's Large Business Office (LBO) and Oil Taxation Office and Custom's Large Business Group were also integrated to form a single HMRC Large Business Service (LBS). The Revenue and Customs' tax functions within HMRC are able to exchange information freely and work together to compare information on particular groups and industries.

Joint investigations

HMRC is able to participate in simultaneous tax examinations with another tax authority using the exchange of information provisions in their respective DTT or, in the case of an EU Member State or other signatory, under the provisions of the OECD/ Council of Europe Convention on Mutual Administrative Assistance in Tax Matters. Such bilateral or multilateral examinations were comparatively rare, although there is now increasing participation by HMRC in 'simultaneous controls' under the Council of Europe/EU Convention, which include TP enquiries.

HMRC was proactively involved with the OECD's Forum on Tax Administration in developing proposals for joint audits on TP cases, whereby HMRC officials may be part of a team including officials from one or more other tax authorities. Together, the team would make a joint assessment of TP risks across a multinational enterprise (MNE), or might jointly audit those risks that affected both tax authorities, or divide up the risks between them. This would have the advantage of reducing the cost to a multinational group of dealing with a number of different audits covering the same transactions, as well as potentially resolving risks of double taxation.

Comparison with OECD Guidelines

The United Kingdom is a member of the OECD and has approved the OECD Guidelines. The UK legislation in TIOPA Part 4 (and formerly, Schedule 28AA of ICTA 88) is required to be construed in a manner that best ensures consistency with the Guidelines (*see the Statutory rules section for more information*). As noted, TIOPA 2010 formally recognises the OECD Guidelines as a result of an amendment to the legislation made in FA 2011 and HMRC applied the updated 2010 Guidelines from 1 April 2011.

HMRC has stated that the comparable uncontrolled price (CUP) method is the simplest and most accurate of the OECD methods and is the preferred method where there are comparable uncontrolled transactions. However, where it is difficult to identify comparable uncontrolled transactions in practice, HMRC looks to use another OECD-approved method, including the TNMM and the profit split method, and looks for the most appropriate method in the circumstances of the case. This reflects HMRC's long-standing acceptance of profit-based methods as well as the 2010 OECD Guidelines, which abolished the hierarchy of methods.

As noted above, HMRC has widely adopted the principles in the OECD Guidelines including the revisions made in 2010 and, therefore, closely follows the OECD guidance on comparability.

United Kingdom

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United States

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Overview

In the United States, transfer pricing (TP) continues to be an area of focus for the US Internal Revenue Service (IRS). Over the last couple of years, changes to the organisational structure of the divisions within the US IRS which administer the advance pricing agreement (APA) and competent authority programmes as well as newly published guidance regarding the information document request (IDR) process during an IRS examination and other directives have led to improved efficiencies and avenues for collaboration between US taxpayers and the IRS. Specifically, this result can be seen in the 2013 APA programme statistics, which noted a record high 145 APAs were executed that year – an increase over the 140 executed in 2012; only 42 APAs were concluded in 2011. At the same time, the average time to complete APAs also decreased.

To address the administrative changes necessary following the internal reorganisation, on 22 November 2013, the IRS concurrently issued Notice 2013-78 and Notice 2013-79, proposing updated and revised revenue procedures for requesting CA assistance under US tax treaties and pursuing APAs, respectively. The public comment period closed on 10 March 2014; final revenue procedures are expected to be issued soon thereafter.

Concurrently with these efforts to streamline processes and promote improved communication and transparency with taxpayers, the IRS has continued to aggressively pursue for examination both US-based multinational enterprises (MNEs) and the US subsidiaries of foreign enterprises engaging in inter-company cross-border transactions. On 14 February 2014, the IRS released its new 'Transfer Pricing Audit Roadmap', which provides IRS practitioners with audit techniques and tools to assist with the planning, execution and resolution of TP examinations. Although available to the public, the roadmap is intended for use by IRS Large Business and International (LB&I) teams in performing a risk assessment of TP issues, and in carrying out a TP examination. Ultimately, the roadmap may also be used as a tool by US taxpayers to better understand the perspective and approach of the IRS examination teams to the review of TP issues under audit, hopefully facilitating more effectual and productive interactions with the IRS.

United States

Country	United States
OECD member?	Y
TP legislation	
Are there statutory TP documentation requirements in place?	Y
Does TP legislation adopt the OECD Guidelines?	N
Does TP legislation apply to cross-border inter-company transactions?	Y
Does TP legislation apply to domestic inter-company transactions?	Y
Does TP legislation adhere to the arm's-length principle?	Y
TP documentation	
Can TP documentation provide penalty protection?	Y
When must TP documentation be prepared?	When the return is filed
Must TP documentation be prepared in the official/local language?	Y
Are related-party transactions required to be disclosed on the tax return?	Y
Penalties	
Are there fines for not complying with TP documentation requirements?	N
Do penalties or fines or both apply to branches of foreign companies?	N
How are penalties calculated?	As a percentage of both the adjustment to taxable income and the adjusted tax due

Introduction

This chapter is devoted to a broad outline of US TP rules and the accompanying penalty regulations. Also covered are the US CA procedures including the APA programme and the interaction of the US rules with the Organisation for Economic Co-operation and Development (OECD) Guidelines.

The importance of the US rules on transfer pricing

The US regulatory environment is of great significance for a number of reasons:

- The United States is an important market for the majority of MNEs, and therefore compliance with US rules, which remain arguably the toughest and most comprehensive in the world, is a considerable issue in international business.
- Beginning in the 1990s, the United States undertook a comprehensive reform of its TP regulations and has continued to update and expand legislation most recently with changes in the cost-sharing, services and intangible property transfer areas. These developments tend to influence other countries to subsequently increase the stringency of their own rules. As such, an understanding of developments in the United States and the controversies surrounding them are good indicators of likely areas of contention in other countries.
- The US's aggressive TP regime has caused controversy with some of its trading partners, not all of whom have entirely agreed with the US's interpretation of the arm's-length standard. The regulations, together with a greater level of enforcement activity, have resulted in an increasing number of TP issues being considered through the CA process under the mutual agreement article of tax treaties concluded between the United States and most of its major trading partners.

- The CA process also forms the basis for the APA programme, which has become a progressively more important mechanism for MNEs to obtain prospective reassurance that their TP policies and procedures meet the requirements of the arm's-length standard as well as an additional mechanism for resolving tax audits involving TP issues.

Non-US tax authorities and practitioners alike have tended to be critical of the level of detail included in the US regulations and procedures. However, in considering the US regime, it is important to bear in mind that unlike many of its major trading partners, the US corporate tax system is a self-assessment system where the burden of proof is generally placed on the taxpayer – leading to a more adversarial relationship between the Government and the taxpayer. This additional compliance burden placed on MNEs by the United States is not unique to the field of TP.

The rationale underlying the US regulations

In 1986, the US Congress ordered a comprehensive study of inter-company pricing and directed the IRS to consider whether the regulations should be modified. This focus on TP reflected a widespread belief that MNEs operating in the United States were often setting their transfer prices in an arbitrary manner, resulting in misstated taxable income in the United States. Additional concerns were raised regarding the difficulty of the IRS to conduct retrospective audits to determine whether the arm's-length standard had been applied in practice, due to the lack of documentation supporting the inter-company pricing schemes.

The history of the US reform process

Since 1934, the arm's-length standard has been used to determine whether cross-border, inter-company TP produces a clear reflection of income for US Federal income-tax purposes. The arm's-length standard has become the internationally accepted norm for evaluating inter-company pricing.

In 1968, the IRS issued regulations that provided procedural rules for applying the arm's-length standard and specific pricing methods for testing the arm's-length character of TP results. These transaction-based methods – the comparable uncontrolled price (CUP) method, the resale price method (RPM), and the cost-plus (CP) method – have gained broad international acceptance.

Congress amended § 482 in 1986, by adding the commensurate with income standard for the transfer of intangible property. At the same time, Congress directed the IRS to conduct a comprehensive study of inter-company TP, the applicable regulations under § 482 of the Code, and the need for new enforcement tools and strategies. The IRS responded to that directive by issuing the White Paper in 1988.

Between 1988 and 1992, Congress added or amended §§ 482, 6038A, 6038C and 6503(k) to impose on taxpayers new information reporting and record-keeping requirements and to provide IRS revenue agents with greater access to that information. In addition, Congress added § 6662(e) and (h) to impose penalties for significant TP adjustments. In 1992, the IRS issued new proposed regulations under § 482. Those regulations implemented the commensurate with income standard and introduced significant new procedural rules and pricing methods. These proposed regulations also included significant new rules for cost-sharing arrangements.

In 1993, the IRS issued temporary regulations that were effective for taxable years beginning after 21 April 1993, and before 6 October 1994. These regulations emphasised the use of comparable transactions between unrelated parties and a flexible application of pricing methods to reflect specific facts and circumstances. The IRS also issued proposed regulations under § 6662(e) and (h), which conditioned the avoidance of penalties upon the development and maintenance of contemporaneous documentation, showing how the pricing methods specified in the § 482 regulations had been applied.

In 1994, the IRS issued temporary and proposed regulations under § 6662(e) and (h), applicable to all tax years beginning after 31 December 1993. The IRS also issued final regulations under § 482, effective for tax years beginning after 6 October 1994 and amended the temporary and proposed § 6662(e) and (h) regulations, retroactive to 1 January 1994.

Also in 1994, final § 482 regulations were issued, which are generally effective for tax years beginning after 6 October 1994. However, taxpayers may elect to apply the final regulations to any open year and to all subsequent years.

In 1995, final regulations on cost-sharing were issued (which were subject to minor modification in 1996). These regulations were effective for taxable years beginning on, or after, 1 January 1996. Existing cost-sharing arrangements were not grandfathered and had to be amended to conform to the final regulations. If an existing cost-sharing arrangement met all of the requirements of the 1968 cost-sharing regulations, participants had until 31 December 1996 to make the required amendments. Major changes to the rules governing cost-sharing transactions were recommended on 22 August 2005, when the IRS issued proposed cost-sharing regulations. These proposed regulations focus on three new specified methods of valuation for determining the arm's-length buy-in amount and are described later in this chapter. At the writing of this chapter, the proposed regulations have not been finalised.

On 9 February 1996, final TP penalty regulations under § 6662 were issued with effect from that date, subject to a taxpayer's election to apply them to all open tax years beginning after 31 December 1993. Revised procedures for APAs were also issued in 1996. In 1998, the IRS simplified and streamlined procedures for APAs for small-business taxpayers.

In 2003, regulations that were proposed in 2002 – dealing with the treatment of costs associated with stock options in the context of qualifying cost-sharing arrangements (*see below*) – were finalised and regulations governing the provision of intragroup services were proposed. The proposed services' regulations were replaced by temporary and proposed regulations (temporary regulations), issued on 31 July 2006. Finally, the new services' regulations were made final on 31 July 2009.

Global dealing regulations, which primarily impact the financial services sector, are expected to clarify how to attribute profits consistent with the TP rules when a permanent establishment (PE) exists. At the writing of this chapter, these regulations have not been finalised.

On 4 March 2014, the Treasury released the General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals, also referred to as the 'Green Book.' The proposals include two items that could have a significant impact on outbound transfers of intangible property:

1. Tax Currently 'Excess' Returns Associated with Transfers of Intangibles Offshore.
2. Limit Shifting of Income Through Intangible Property Transfers.

The first proposal is essentially identical to the proposal in last year's budget, which is largely the same as that which appeared in the prior year's budget. The proposal would provide that if a US person transfers (directly or indirectly) an intangible from the United States to a related CFC (a 'covered intangible'), then certain excess income from transactions connected with, or benefitting from, the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10% or less, the proposal would treat all excess income as Subpart F income, and would then ratably phase out for effective tax rates of 10–15%. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with, or benefitting from, such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage markup. For the purposes of this proposal, the transfer of an intangible includes sale, lease, license, or any shared risk or development agreement (including any cost-sharing arrangement). This subpart F income will be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under § 904. The second proposal is identical to the version presented in last year's budget. This proposal would clarify the definition of intangible property for purposes of §§ 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the commissioner may value intangible property, taking into consideration the prices or profits that the controlled taxpayer could have realised by choosing a realistic alternative to the controlled transaction undertaken.

A key factor influencing the future of US Federal corporate income-tax policy and, in turn, US TP policy, will likely be the outcome of the 2014 midterm election and the 2016 US presidential election as the two primary US political parties have different points of view with respect to corporate taxation. The increasing popularity of the fiscal conservative movement among traditionally moderate voters as well as domestic concerns about inflation and unemployment likely will also play a role in electing the next US president and will ultimately influence US Federal corporate income-tax policy.

Consistency between the US regulations and the OECD Guidelines

At the same time as the reform process was progressing in the United States, the OECD was also revising its guidelines on TP (*see Chapter 3*). The OECD Guidelines are a significant point of reference for many of the US's major trading partners in dealing with TP issues. The extent to which the OECD Guidelines are consistent with the US approach is thereby a critical issue for all MNEs that wish to be in full compliance with local laws in all the jurisdictions in which they operate and at the same time mitigate the risk of double taxation and penalties. The substantive provisions of the US regulations are compared to the OECD Guidelines in this chapter (*see Comparison with the OECD Transfer Pricing Guidelines section, below*).

United States

Legislation and guidance

Section 482 of the Internal Revenue Code of 1986 (as amended) provides that the Secretary of the Treasury has the power to make allocations necessary to "prevent evasion of taxes or clearly to reflect the income of…organizations, trades or businesses." It also provides that in respect of intangible property transactions, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Detailed Treasury Regulations promulgated under § 482 are the main source of interpretation of both the arm's-length standard and the commensurate with income standard.

The US transfer pricing regulations

The Best Method Rule

A taxpayer must select one of the pricing methods specified in the regulations to test the arm's-length character of its transfer prices. Under the Best Method Rule, given the facts and circumstances of the transactions under review, the pricing method selected should provide the most reliable measure of an arm's-length result, relative to the reliability of the other potentially applicable methods. In other words, while there may be more than one method that can be applied to a given set of facts and circumstances, the method that yields the most accurate, or best, result should be selected. The relative reliability of the various transaction-based pricing methods depends primarily upon:

- the use of comparable uncontrolled transactions (CUTs) and the degree of comparability between those transactions and the taxpayer's transactions under review, and
- the completeness and accuracy of the underlying data, and the reliability of the assumptions made and the adjustments required to improve comparability.

Adjustments must be made to the uncontrolled comparables if such adjustments will improve the reliability of the results obtained under the selected pricing method. Determination of the degree of comparability will be based on a functional analysis made to identify the economically significant functions performed, assets employed, and risks borne by the controlled and uncontrolled parties involved in the transactions under review.

Industry average returns cannot be used to establish an arm's-length result, except in rare instances where it can be demonstrated that the taxpayer establishes its inter-company prices based on such market or industry indices and that other requirements are complied with. Unspecified methods may be used if it can be shown that they produce the most reliable measure of an arm's-length result. A strong preference is given to transactional (as opposed to profits-based) methods that rely on external data and CUTs. When using a specified method, a taxpayer is not required to demonstrate the inapplicability of other methods before selecting its preferred method. However, in order to avoid potential penalties, a taxpayer must demonstrate with contemporaneous documentation that it has made a reasonable effort to evaluate the potential applicability of other methods before selecting its best method (*see The US penalty regime section, below*).

The arm's-length range

No adjustment will be made to a taxpayer's TP results if those results are within an arm's-length range derived from two or more CUTs. This concept of a range of acceptable outcomes rather than a single arm's-length answer is the key to understanding the flexible application of the arm's-length standard that underlies the US regulations.

Under the regulations, the arm's-length range will be based on all of the comparables, only if each comparable meets a fairly high standard of comparability. If inexact comparables are used, the range ordinarily will be based only on those comparables that are between the 25th and 75th percentile of results. However, other statistical methods may be used to improve the reliability of the range analysis.

If a taxpayer's TP results are outside the arm's-length range, the IRS may adjust those results to any point within the range. Such an adjustment will ordinarily be to the median of all the results.

The regulations permit comparisons of controlled and uncontrolled transactions based upon average results over an appropriate multiple-year period. If a taxpayer's results are not within the arm's-length range calculated using multiple-year data the adjustment for a year may be based on the arm's-length range calculated using data from only that year.

Collateral adjustments and set-offs

A taxpayer is required to report an arm's-length result on its tax return, even if those results reflect transfer prices that are different from the prices originally set out on invoices and in the taxpayer's books and records, and may be subjected to substantial penalties if they fail to do so. This provision has no direct equivalent in the tax codes of most of the US major trading partners and may result in double taxation of income.

In the event of an income adjustment under § 482 involving transactions between US entities, the IRS is required to take into account any appropriate collateral adjustment. For example, should the income of one member of the controlled group be increased under § 482, other members must recognise a corresponding decrease in income. This should be distinguished from the treatment of foreign initiated adjustments where it will be necessary to invoke a CA process as the only means of obtaining a corresponding adjustment in the United States (*see below*).

Taxpayers may also claim set-offs to the extent that it can be established that other transactions were not conducted at arm's length. The regulations limit such set-offs to transactions between the same two taxpayers within the same taxable year.

Impact of foreign legal restrictions

The regulations include provisions that attempt to limit the effect of foreign legal restrictions on the determination of an arm's-length price. In general, such restrictions will be taken into account, only if those restrictions are publicly promulgated and affect uncontrolled taxpayers under comparable circumstances. The taxpayer must demonstrate that it has exhausted all remedies prescribed by foreign law, the restrictions expressly prevent the payment or receipt of the arm's-length amount, and the taxpayer (or the related party) did not enter into arrangements with other parties that had the effect of circumventing the restriction. The regulations also attempt to force the use of the deferred income method of accounting where foreign legal restrictions do limit the ability to charge an arm's-length price.

Transfers of tangible property
The regulations governing the transfer of tangible property have not changed substantially since 1992. They continue to focus on comparability of products under the CUP method, and the comparability of functions under the resale price and CP methods. Comparability adjustments under the regulations must consider potential differences in quality of the product, contractual terms, level of the market, geographic market, date of the transaction and other issues. In addition, the regulations require consideration of potential differences in business experience and management efficiency.

Transfers of intangible property
The implementation of the commensurate with income standard has been a considerable source of controversy between the United States and its trading partners. Some have interpreted the intent of the regulations to be the consideration for the transfer of an intangible asset, which is subject to adjustment long after the transfer takes place. This approach has been viewed as inconsistent with the way unrelated parties would interact with one another. The primary objective of this provision is to ensure that the IRS has the right to audit the reliability of the assumptions used in setting the transfer price for an intangible asset to determine whether the transfer had been made at arm's length. As such, the regulations provide a detailed description of how the consideration paid for an intangible asset will be evaluated consistent with the statutory requirement that the consideration be commensurate with the income derived from exploitation of the intangible.

In general terms, the need for periodic adjustment to transfer prices for intangible property depends upon whether the TP method used to set the transfer price relies on projected results (projected profit or cost savings). No periodic adjustments will be required if the actual cumulative benefits realised from exploitation of the intangible are within a range of plus or minus 20% of the forecast. If the actual benefits realised fall outside this range, the assumption is that the transfer price will be re-evaluated unless any of the further extraordinary event exceptions detailed in the regulations are satisfied. The intent behind these regulations is to replicate what would occur in a true third-party relationship if, for example, one party to a licence arrangement found that unanticipated business events made the level of royalty payments economically not viable. It also prevents a taxpayer from manipulating a forecast of benefits that would result in a significantly different purchase price for the intangible.

If no adjustment is warranted for each of the five consecutive years following the transfer, the transfer will be considered to be at arm's length and consequently no periodic adjustments will be required in any subsequent year. If an adjustment is warranted, there have been recent debates as to whether a taxpayer can affirmatively invoke the commensurate with income standard. Under the 2003 proposed cost-sharing regulations, the IRS posits that only the commissioner has the right to invoke the commensurate with income standard and not the taxpayer.

All prior regulations (including those issued in 1968, 1992 and 1993, respectively) provided that, for TP purposes, intangible property generally would be treated as being owned by the taxpayer that bore the greatest share of the costs of development of the intangible. In contrast, the 1994 final regulations provide that if an intangible is legally protected (e.g. patents, trademarks and copyrights) the legal owner of the right to exploit an intangible ordinarily will be considered the owner for TP purposes. In the case of intangible property that is not legally protected (e.g. know-how) the owner continues to be the party that bears the greatest share of the costs of development.

The regulations provide that legal ownership of an intangible is determined either by operation of law or by contractual agreements under which the legal owner has transferred all or part of its rights in the intangible to another party. In determining legal ownership of the intangible, the final regulations provide that the IRS may impute an agreement to convey ownership of the intangible if the parties' conduct indicates that, in substance, the parties have already entered into an agreement to convey legal ownership of the intangible.

The temporary regulations issued on 1 July 2006 maintained the 1994 final regulations' treatment for legally protected intangibles (i.e. the legal owner of the rights to exploit an intangible ordinarily will be considered the owner for TP purposes). However, the temporary regulations redefined the definition of 'owner' (for TP purposes) of intangible property rights that are not legally protected. Unlike the existing regulations, which assigns ownership of such intangibles to the party that bears the largest portion of the costs of development, the temporary regulations redefine the owner of such intangibles as the party that has the 'practical control' over the intangibles, therefore, eliminating the old 'developer-assister' rule altogether.

Given this position, the possibility still exists that there may be a difference of opinion between the United States and other taxing jurisdictions as to whom the primary owner of some categories of intangible assets may be, for TP purposes. For example, taxpayers may find that because proprietary rights' strategies can vary from country to country, the treatment of intangibles may not be consistent across countries, even though the economic circumstances are the same. Taxpayers may also find that trademarks are deemed to be owned by one party, while the underlying product design and specifications are deemed to be owned by a different party. Multinational corporations should take these potential differences of opinion into account in planning their inter-company pricing policies and procedures.

The IRS has provided rules for determining how the commensurate with income standard should be applied to lump-sum payments. Such payments will be arm's length and commensurate with income if they are equal to the present value of a stream of royalty payments where those royalty payments can be shown to be both arm's length and commensurate with income.

In February 2007, the IRS issued an Industry Directive indicating the likely direction that future IRS audits will take regarding migrations of intangible property. The Industry Directive primarily targets pharmaceutical and other life sciences' companies that transferred the operations of former § 936 possessions corporations to controlled foreign corporations (CFCs). More broadly, the Industry Directive underscores the attention that the IRS has been paying to issues surrounding intangible migration transactions. On 27 September 2007, the IRS issued Coordinated Issue Paper (CIP) (LMSB-04-0907-62), addressing buy-in payments associated with cost-sharing arrangements. The CIP covers all industries, suggesting that the IRS is preparing to more rigorously analyse and examine the key operations and risks related to the migration of intangible assets going forward. On 19 January 2012, IRS Transfer Pricing Director, Samuel Maruca, announced that the CIP would be withdrawn. The withdrawal of the CIP is mostly a formality as the final cost-sharing regulations were issued on 16 December 2011 (*see Cost-sharing, below*).

Intangibles embedded in the provision of intragroup services
In July 2006, the Treasury Department and the IRS issued temporary and proposed regulations governing the provision of intragroup services. Following a protracted period of public commentary and a transition phase, new services' regulations were issued on 31 July 2009.

The new regulations emphase the interaction between intragroup services and the use of intangible property, and provide numerous examples of situations where a provider of intragroup services would earn higher margins, or could be expected to share in the profits of the development of intangible property that is jointly developed by the owner of the property and the service provider. Research and development (R&D), and the development of marketing intangible assets in a local market, are examples of high-value services provided in conjunction with intangible property.

The comparable profits method
The comparable profits method (CPM) may be used to test the arm's-length character of transfers of both tangible and intangible property. The CPM evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability, known as 'profit level indicators,' derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Differences in functions performed, resources used and risks assumed between the tested party and the comparables should be taken into account in applying this method.

Profit split methods
Profit split methods (PSMs) are specified methods for testing the arm's-length character of transfers of both tangible and intangible property. However, the emphasis on comparable transactions throughout the regulations is intended to limit the use of PSMs to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable uncontrolled comparables under some other method. Profit split methods are appropriate when both parties to a transaction own valuable non-routine intangible assets.

Specified PSMs are limited to either (i) the comparable PSM, which makes reference to the combined operating profit of two uncontrolled taxpayers dealing with each other and whose transactions are similar to those of the controlled taxpayer, or (ii) the residual PSM, which allocates income first to routine activities using any of the other methods available and then allocates the residual income based upon the relative value of intangible property contributed by the parties. No other PSMs are treated as specified methods under the final regulations (although other forms of profit splits might be used, if necessary, as unspecified methods). The temporary regulations expanded the potential applications of the residual PSM. Whereas under the existing regulations the residual profit is split between the parties that contribute valuable non-routine intangibles, the temporary regulations suggest the residual profits can be split between parties that provide non-routine contributions (not necessarily intangibles) to the commercial venture.

The US cost-sharing regulations
On 16 December 2011, the IRS and the Treasury Department issued final cost-sharing regulations (Final Regulations) that were previously issued as temporary and proposed regulations (2008 Temporary Regulations) on 31 December 2008, providing guidance on the treatment of cost-sharing arrangements (CSAs). The Final Regulations largely continue the guidance contained in the 2008 Temporary Regulations, which were

set to expire on 30 December 2011. Subsequently, on 19 December 2011, the IRS and Treasury Department issued additional cost-sharing rules in the form of temporary regulations (2011 Temporary Regulations), which provide further guidance on the evaluation of discount rates in applying the income method. At the same time, the IRS and Treasury Department also issued proposed regulations (2011 Proposed Regulations), which propose to include a new specified application of the income method based on the use of the 'differential income stream.'

The Final Regulations are applicable commencing on 16 December 2011, the date they were filed with the Federal Register, and are generally applicable to all CSAs with a continuation of the transition rules in the 2008 Temporary Regulations that apply to CSAs in existence on 5 January 2009. The 2011 Temporary Regulations are effective as of 19 December 2011. The comment period for the 2011 Proposed Regulations closed on 21 March 2012, 90 days following their publication in the Federal Register.

Determining platform contribution transactions

The 2008 Temporary Regulations introduced five specified methods for valuing cost-sharing buy-ins, now referred to as platform contribution transactions (PCTs) and provide guidance on the use of the Best Method Rule in determining the value of PCTs. These specified methods include the CUT method, income method, acquisition price method, residual PSM, and market capitalisation method. In addition, the 2008 Temporary Regulations confirmed the use of the arm's-length range in determining the value of PCTs.

The 2008 Temporary Regulations also significantly changed the application of the 'Investor Model,' a concept introduced in the proposed regulations issued in August 2005 (August 2005 Proposed Regulations). The Investor Model assesses the reliability of a method based on its consistency with the assumption that the rate of return anticipated at the date of a PCT for both the licensor and licensee must be equal to the appropriate discount rate for the CSA activity. Furthermore, this model indicates that the present value of the income attributable to the CSA for both the licensor and licensee must not exceed the present value of income associated with the best realistic alternative to the CSA. In the case of a CSA, the 2008 Temporary Regulations indicated that such an alternative is likely to be a licensing arrangement with appropriate adjustments for the different levels of risk assumed in such arrangements.

Through the 2008 Temporary Regulations, the IRS recognised that discount rates used in the present value calculation of PCTs can vary among different types of transactions and forms of payment.

While the Final Regulations generally adopt the principles and TP methods described in the 2008 Temporary Regulations to value a platform contribution, and in particular the reliance on the Investor Model, the Final Regulations provide further clarification on the parameters used in the application of the specified methods, such as tax rates and discount rates. The Final Regulations clarify that the 'tax rate' for purposes of determining amounts on a pre-tax basis refers to the "reasonably anticipated effective rate with respect to the pre-tax income to which the tax rate is being applied (PCT Payor or PCT Payee)".

Definition of intangibles and intangible development area
The scope of the intangible development area under the 2008 Temporary Regulations was meant to include all activities that could reasonably be anticipated to contribute to the development of the cost-shared intangibles. To that end, the 2008 Temporary Regulations stated that the intangible development area must not merely be defined as a broad listing of resources or capabilities to be used, and introduced the concept that any 'resource, right or capability' – including resources contributed in the form of services, for example – must be compensated. The Final Regulations ensure that this concept is consistently reflected throughout the regulatory language by referring to 'resource, capability or right' rather than 'intangibles' as in the 2008 Temporary Regulations.

The 2008 Temporary Regulations also broadened the scope of external contributions that must be compensated as PCTs to include the value of services provided by a research team. Such a team would represent a PCT, for which a payment is required over and above the team's costs, included in the cost-sharing pool. This concept is maintained in the Final Regulations.

Periodic adjustments
A significant change in the 2008 Temporary Regulations, which remains unchanged in the Final Regulations, was the so-called 'periodic adjustment' rule, which allows the IRS (but not the taxpayer) to adjust the payment for the PCT, based on actual results. Unlike the 'commensurate with income' rules the 2008 Temporary Regulations provided a cap on the licensee's profits (calculated before cost-sharing or PCT payments), equal to 1.5 times its 'investment'. (For this purpose, both the profits and 'investment' are calculated on a present value basis.) That is, if the licensee 'profit' is in excess of 1.5 times its PCT and cost-sharing payments on a present value basis, an adjustment is made using the 2008 Temporary Regulations' version of the residual PSM. In the example in the 2008 Temporary Regulations, this adjustment leaves the licensee with a 10% markup on its non-cost-sharing (non-R&D) expenses, leaving it with only a routine return. Notably, this periodic adjustment is waived if the taxpayer concludes an APA with the IRS on the PCT payment. The Final Regulations also added a third example providing guidance on applying the periodic adjustment when more than two parties are involved in a CSA requiring multiple periodic adjustments each year.

There is also an exception for 'grandfathered' CSAs, whereby the periodic adjustment rule of the 2008 Temporary Regulations is applied only to PCTs occurring on, or after, the date of a 'material change' in scope of the intangible development area (but *see below for additional commentary*). The 2008 Temporary Regulations also provide exceptions to the periodic adjustment rule in cases where the PCT is valued under a CUT method involving the same intangible and in situations where results exceed the periodic adjustment cap, due to extraordinary events beyond control of the parties.

Transition rules
The Temporary Regulations specify that CSAs in place on, or before, 5 January 2009 must meet certain administrative requirements in order to continue to be treated as CSAs.

The Temporary Regulations indicate that PCT payments made under CSAs in existence on, or before, 5 January 2009 will not be subject to the periodic adjustment rules described above, but rather will be governed by the commensurate with income

adjustment rules. However, there is an exception for PCTs occurring on, or after, a material change in scope in the CSA, which includes "a material expansion of the activities undertaken beyond the scope of the intangible development area". A determination of 'material change in scope' is made on a cumulative basis, such that a number of smaller changes may give rise to a material change in the aggregate. In addition, grandfathered CSAs are not subject to the requirement of non-overlapping and exclusive divisional interests.

Reasonably Anticipated Benefit Shares
The 2008 Temporary Regulations made an important change to the requirements under which reasonably anticipated benefit (RAB) ratios are calculated for CSAs. There is now an explicit requirement that RAB ratios be computed using the entire period of exploitation of the cost-shared intangibles. The Final Regulations include new language that explicitly prohibits any retroactive change to RAB shares for prior years, based on updated information regarding relative benefits, which was not available in the prior year.

The US services regulations
US services regulations were originally issued in 1968, and included the cost safe harbour rule allowing certain services to be charged at cost. On 10 September 2003, the IRS issued new proposed regulations for the treatment of controlled services transactions, which included a new cost method, the simplified cost-based method (SCBM), introduction of shared services' arrangements, and required stock-based compensation to be included in the pool of total services' costs.

On 4 August 2006, the IRS issued new temporary and proposed services' regulations in response to practitioners' feedback from the 2003 proposed regulations. As anticipated, the IRS and Treasury issued final § 482 regulations on 31 July 2009, effective as of that date and applying to taxable years beginning after that date. These regulations provide guidance regarding the treatment of controlled services' transactions under § 482 and the allocation of income from intangible property. Additionally, these regulations modify the final regulations under § 861 concerning stewardship expenses to be consistent with the changes made to the regulations under § 482.

Controlled taxpayers may elect to apply retroactively all of the provisions of these regulations to any taxable year beginning after 10 September 2003. Such election will be effective for the year of the election and all subsequent taxable years.

The final service regulations require taxpayers to apply the arm's-length standard in establishing compensation amounts for the provision of inter-company services. Therefore, similar to other sections of the TP regulations, taxpayers involved in the provision of inter-company services must adhere to the best method, comparability and the arm's-length range requirements of Treas. Reg. § 1.482-1. What is new is that the final service regulations stipulate that taxpayers must apply one of the six specified TP methods or an unspecified method in evaluating the appropriateness of their inter-company services' transactions. The six specified TP methods include three transactional approaches, two profit-based approaches and a cost-based safe harbour. The transactional approaches are the comparable uncontrolled services price method (CUSPM), the gross services margin method (GSMM) and the cost of services plus method (CSPM). The two profit-based approaches are the existing CPM and the PSM. The cost-based safe harbour is the services cost method (SCM).

Services cost method (SCM)
The new services regulations, consistent with the 2006 regulations, include the SCM, which replaced the previously proposed SCBM. Taxpayers employing the SCM must state their intention to apply this method to their services in detailed records that are maintained during the entire duration that costs relating to such services are incurred. The records must include all parties involved (i.e. renderer and recipient) and the methods used to allocate costs.

The new regulations make certain clarifying changes to the provisions dealing with the SCM. The final regulations incorporate the clarifications and changes previously issued in Notice 2007-5, 2007-1 CB 269. Aside from these changes and certain other minor, non-substantive modifications, the provisions in the final regulations relating to the SCM and other TP methods applicable to controlled services' transactions are essentially the same as those in the temporary regulations.

In addition to the good list and the low-margin services, a taxpayer must also comply with the business judgment rule, which was effective for taxable years beginning after 31 December 2006, under the proposed and temporary services regulations. This rule requires taxpayers to conclude that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or business of the renderer, the recipient, or both.

Consequently, like the temporary regulations, the final regulations provide that services may qualify for the SCM only if they are either 'specified covered services' as described in Revenue Procedure 2007-13, 2007-1 C.B. 295, or are services for which the median arm's-length markup is 7% or less. In addition, the services must continue to satisfy the business judgment rule, which in the final regulations is consistent with the temporary regulations as clarified by Notice 2007-5. With respect to 'specified covered services' that may be eligible for the SCM, the IRS and Treasury believe that the list of specified covered services issued in Revenue Procedure 2007-13 is generally appropriate, although they will consider recommendations for additional services to be added to the list in the future.

The regulations also specifically mention services where the SCM cannot be employed; these services include:

- manufacturing
- production
- extraction, exploration or processing of natural resources
- construction
- reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or similar arrangement, R&D, or experimentation
- financial transactions including guarantees, and
- insurance or reinsurance.

The comparable uncontrolled services price method (CUSPM)
The CUSPM is analogous to the CUP and the CUT. Under the CUSPM, the price charged in comparable uncontrolled services transactions form the basis of evaluating the appropriateness of the controlled services transaction. Generally, the CUSPM is applicable in situations where the related-party services are similar (or have a high degree of similarity) to the comparable uncontrolled services transactions.

The gross services margin method (GSMM)

The GSMM is comparable to the RPM of the tangible property TP regulations. Under this method, evaluating the appropriateness of inter-company services' pricing arrangements relies on the gross profit margins earned in comparable uncontrolled services transactions as benchmarks. The GSMM is appropriate in situations where a controlled taxpayer provides services (e.g. agency or intermediary services) in connection with a related uncontrolled transaction involving a member of the controlled group and a third party.

The cost of services plus method (CSPM)

The CSPM is analogous to the cost-plus (CP) method of the tangible property TP regulations. Like the CP method, the CSPM evaluates the appropriateness of inter-company services' TP arrangements by reference to the gross services profit markup earned in comparable uncontrolled services transactions. The CSPM is appropriate when the service providing entity provides the same or similar services to both related and third parties.

Contractual arrangements and embedded intangibles

In analysing transactions involving intangible property, the new services regulations have retained the emphasis on the importance of legal ownership. When intangible property is embedded in controlled services transactions, the economic substance must coincide with the contractual terms and must be in accord with the arm's-length standard.

Ownership of intangibles

The new services' regulations have issued new guidance surrounding the ownership of intangibles. For TP purposes, the owner for legally protected intangibles is the legal owner. However, in the case of non-legally protected intangibles, the owner is the party with 'practical control' over the intangible. When the legal ownership standard is inconsistent with 'economic substance,' these rules may be dismissed. The new services' regulations eliminate the possibility of multiple ownership of a single intangible as was the case under the 'developer-assister' rule in the prior regulations.

The final regulations continue without significant change in the provisions of the temporary regulations for identifying the owner of an intangible for TP purposes, and for determining the arm's-length compensation owing to a party that contributes to the value of an intangible owned by another controlled party. Therefore, the final regulations reflect the continuing view of the IRS and Treasury that legal ownership provides the appropriate framework for determining ownership of intangibles. The legal owner is the controlled party that possesses legal ownership under intellectual property law, or that holds rights constituting an intangible pursuant to contractual terms (such as a license), unless such ownership is inconsistent with the economic substance of the underlying transactions.

Benefit test

An activity provides a benefit if it directly results in a reasonably identifiable increment of economic or commercial value to the service recipient. The final services' regulations look at benefit, primarily from the service recipient's perspective.

The final service regulations permit the sharing or allocation of centralised service activities or corporate headquarters' costs, only in situations in which there is an identifiable benefit to the recipients, attributed to the charged-out costs. The final

services' regulations state that activities that provide only an indirect or remote benefit, duplicative activities, shareholder activities and passive association are not beneficial services for recipients. Therefore, recipients are not liable for such costs under the service regulations.

Pass-through costs
The new regulations further clarify the rules for 'pass-through' of external costs without a markup. This generally applies to situations in which the costs of a controlled service provider include significant charges from uncontrolled parties. Rather than have these costs permitted to 'pass-through' and not be subject to a markup under the TP method used to analyse the controlled services transaction, the new regulations allow for the evaluation of the third-party costs (if material) to be evaluated on a disaggregated basis from the covered service transaction.

Passive association benefits
A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for the purposes of evaluating comparability between controlled and uncontrolled transactions.

Stewardship and shareholder activities
The final regulations continue without significant change to the provisions of the temporary regulations dealing with 'stewardship expenses'. These provisions include the provisions under the § 482 regulations for determining whether an activity constitutes a service to a related party for which arm's-length compensation is due, or instead constitutes solely a stewardship activity. They also include the related regulatory provisions under § 861, dealing with the allocation and apportionment of expenses. As noted above, like the temporary regulations, the final regulations under Treas. Reg. § 1.861-8(e)(4) concerning stewardship expenses have been modified to be consistent with the language relating to controlled services transactions in Treas. Reg. § 1.482-9(l). Stewardship expenses, which are defined in the final regulations as resulting from 'duplicative activities' or 'shareholder activities' (as defined in Treas. Reg. § 1.482-9(l)), are allocable to dividends received from the related corporation. The final regulations maintain the narrowed definition of 'shareholder activities', which includes only those activities whose 'sole effect' (rather than 'primary effect') is to benefit the shareholder. Examples include:

- preparation and filing of public financial statements, and
- internal audit activities.

Stock-based compensation
The IRS received a number of comments on the regulatory provision that requires stock-based compensation to be included in 'total services costs' for the purposes of the SCM. Some commentators requested further guidance on valuation, comparability and reliability considerations for stock-based compensation, while others objected to the statement that stock-based compensation can be a services' cost. On this somewhat controversial issue, the IRS and Treasury deferred consideration of the comments. The Preamble to the final regulations states: "These final regulations do not provide further guidance regarding stock-based compensation. The Treasury Department and the IRS continue to consider technical issues involving stock-based compensation in

the services and other contexts and intend to address those issues in a subsequent guidance project."

Shared services' arrangements
The final regulations provide guidance on the shared service arrangements (SSAs), which applies to services that otherwise qualify for the SCM, i.e. are not subject to a markup. Costs are allocated, based on each participant's share of the reasonably anticipated benefits from the services with the actual realisation of benefit bearing no influence on the allocation. The taxpayer is required to maintain documentation stating the intent to apply the SCM for services under an SSA.

Financial guarantees
Financial guarantees are excluded as eligible services for application of the SCM, because the provision of financial transactions, including guarantees, requires compensation at arm's length under the final regulations.

Economic substance, realistic alternatives and contingent payment services
The final regulations are consistent with the temporary regulations regarding the IRS's authority to impute contractual terms to be consistent with the economic substance of a related-party transaction including the provisions addressing contingent payment services' transactions. Provisions authorising the IRS to consider realistic alternatives in evaluating the pricing of controlled services' transactions also remain unchanged. The Preamble to the final regulations, and certain clarifying changes to the regulatory language, emphasise that the evaluation of economic substance must be based on the transaction and risk allocation actually adopted by the related parties and based on the actual conduct of the parties, and that IRS is not authorised to impute a different agreement solely because there is a dispute regarding the TP of the transaction. In addition, the Preamble emphasises that the 'realistic alternatives' principle does not permit the IRS to recast a controlled transaction as if the alternative transaction had been adopted, but rather permits the IRS only to consider alternatives in evaluating what price would have been acceptable to a controlled party.

Penalties

The final penalty regulations

The IRS has stated that the objective of the penalty regime is to encourage taxpayers to make reasonable efforts to determine and document the arm's-length character of their inter-company transfer prices. The regulations provide guidance on the interpretation of 'reasonable efforts'.

With respect to TP, the transactional penalty applies to individual transactions in which the transfer price is determined not to be arm's length by the IRS. The regulations impose a 20% non-deductible transactional penalty on a tax underpayment attributable to a transfer price claimed on a tax return that is 200% or more, or 50% or less than the arm's-length price. The penalty is increased to 40% if the reported transfer price is 400% or more, or 25% or less than the arm's-length price. Where these thresholds are met, the TP penalty will be imposed unless the taxpayer can demonstrate reasonable cause and good faith in the determination of the reported transfer price.

In certain instances, based on the sum of all increases and decreases in taxable income, which results from a series of transactions in which the transfer price is determined

by the IRS to not be arm's length, a net adjustment penalty may apply. A 20% net adjustment penalty is imposed on a tax underpayment attributable to a net increase in taxable income caused by a net TP adjustment that exceeds the lesser of USD 5 million or 10% of gross receipts. The penalty is increased to 40% if the net TP adjustment exceeds USD 20 million or 20% of gross receipts. Where these thresholds are met, the TP penalty can be avoided, only if a taxpayer can demonstrate that it had a reasonable basis for believing that its TP would produce arm's-length results, and that appropriate documentation of the analysis upon which that belief was based, existed at the time the relevant tax return was filed and is turned over to the IRS within 30 days of a request. The principal focus of the TP regulations is on these documentation requirements that must be met if a taxpayer is to avoid the assessment of a net adjustment penalty.

Under this penalty regime, it is entirely possible that a taxpayer could be assessed a transactional penalty but no net adjustment penalty at one end of the spectrum, or could be assessed a net adjustment penalty but no transaction penalty at the other. However, only one penalty, at the highest applicable rate, will be applied. The same underpayment in taxes will not be penalised twice. Regardless of the penalty, whether an underpayment of tax is attributable to non-arm's-length TP is determined from the results reported on an income tax return, without consideration as to whether those reported results differ from the transaction prices initially reflected in a taxpayer's books and records. An amended tax return will be used for this purpose if it is filed before the IRS has contacted the taxpayer regarding an examination of the original return. A US TP penalty is not a no fault penalty. Even if it is ultimately determined that a taxpayer's transfer prices were not arm's length and the thresholds for either the transactional penalty or net adjustment penalty are met, a penalty will not be imposed if the taxpayer can demonstrate that based upon reasonably available data, it had a reasonable basis for concluding that its analysis of the arm's-length character of its TP was the most reliable, and that it satisfied the documentation requirements set out in the new final regulations.

The US CA has stated that TP penalties will not be subject to negotiation with tax treaty partners in connection with efforts to avoid double taxation.

The reasonableness test

A taxpayer's analysis of the arm's-length character of its TP will be considered reasonable if the taxpayer selects and applies in a reasonable manner a TP method specified in the TP regulations. To demonstrate that the selection and application of a method was reasonable, a taxpayer must apply the Best Method Rule and make a reasonable effort to evaluate the potential application of other specified pricing methods. If a taxpayer selects a TP method that is not specified in the regulations, the taxpayer must demonstrate a reasonable belief that none of the specified methods was likely to provide a reliable measure of an arm's-length result, and that the selection and application of the unspecified method would provide a reliable measure of an arm's-length result.

In applying the Best Method Rule, the final regulations make it clear that ordinarily it will not be necessary to undertake a thorough analysis under every potentially applicable method. The final regulations contemplate that in many cases the nature of the available data will readily indicate that a particular method will or will not likely provide a reliable measure of an arm's-length result. Consequently, a detailed analysis of multiple TP methods should not be necessary except in unusual and complex cases.

The regulations specify that the following seven factors should be considered in determining whether a taxpayer's selection and application of a TP method has been reasonable:

- The experience and knowledge of the taxpayer and its affiliates.
- The availability of accurate data and the thoroughness of the taxpayer's search for data.
- The extent to which the taxpayer followed the requirements of the TP regulations.
- The extent to which the taxpayer relied upon an analysis or study prepared by a qualified professional.
- Whether the taxpayer arbitrarily sought to produce TP results at the extreme point of the arm's-length range.
- The extent to which the taxpayer relied on an APA applicable to a prior tax year, or a pricing methodology specifically approved by the IRS during an examination of the same transactions in a prior year.
- The size of a TP adjustment in relation to the magnitude of the inter-company transactions out of which the adjustment arose.

In determining what level of effort should be put into obtaining data on which to base a TP analysis, a taxpayer may weigh the expense of additional research against the likelihood of finding new data that would improve the reliability of the analysis. Taxpayers are not required to search for relevant data after the end of the tax year, but are required to retain any relevant data that is in fact acquired after the year-end, but before the tax return is filed.

Documentation

To avoid a TP penalty, a taxpayer must maintain sufficient documentation to establish that it reasonably concluded that, given the available data, its selection and application of a pricing method provided the most reliable measure of an arm's-length result and must provide that documentation to the IRS within 30 days of a request for it, in connection with an examination of the taxable year to which the documentation relates.

The announcement on 23 January 2003 by the commissioner of the IRS LB&I Division (formerly, Large and Mid-size Business) indicates that the IRS is stepping up enforcement of the 30-day rule and adopting a standard practice of requiring field examiners to request a taxpayer's contemporaneous documentation within 30 days at the commencement of every examination of a taxpayer with significant inter-company transactions.

There is no requirement to provide any documentation to the IRS in advance of such a request and the tax return disclosure requirements relating to the use of unspecified methods, the PSM and lump-sum payments for intangibles originally included in the 1993 temporary regulations were not retained in the final regulations. In this respect, the US regime is less onerous than some other jurisdictions (e.g. Canada, Australia and India). However, in contrast, it should be noted that the IRS apparently is enforcing tax return disclosure requirements relating to the existence of CSAs (*see above*).

Principal documents
To meet this documentation requirement the following principal documents, which must exist when the relevant tax return is filed, should accurately and completely describe the basic TP analysis conducted by a taxpayer:

- An overview of the taxpayer's business including an analysis of economic and legal factors that affect TP.
- A description of the taxpayer's organisational structure including an organisational chart covering all related parties engaged in potentially relevant transactions.
- Any documentation specifically required by the TP regulations.
- A description of the selected pricing method and an explanation of why that method was selected.
- A description of alternative methods that were considered and an explanation of why they were not selected.
- A description of the controlled transactions including the terms of sale and any internal data used to analyse those transactions.
- A description of the CUTs, or parties that were used with the TP method, how comparability was evaluated and what comparability adjustments were made, if any.
- An explanation of the economic analysis and projections relied upon in applying the selected TP method.

The following additional principal documents must also be maintained by a taxpayer and must be turned over to the IRS within the 30-day period, but do not have to exist at the time the relevant tax return is filed:

- A description of any relevant data that the taxpayer obtains – after the end of the tax year and before filing a tax return – that would be useful in determining whether the taxpayer's selection and application of its TP method was reasonable.
- A general index of the principal and background documents related to its TP analysis and a description of the record-keeping system used for cataloguing and accessing these documents.

Background documents
Background documents include anything necessary to support the principal documents, including documents listed in the § 6038A regulations, which cover information that must be maintained by foreign-owned corporations. Background documents do not need to be provided to the IRS in connection with a request for principal documents, but if the IRS makes a separate request for background documents, they must be provided within 30 days.

The regulations provide that the 30-day requirement for providing documentation to the IRS applies only to a request issued in connection with an examination of the tax year to which the documentation relates. The IRS has stated that it may also seek to obtain transfer pricing documentation (TPD) related to subsequent tax years as well. A taxpayer is not required to comply with that request within 30 days in order to avoid potential TP penalties.

ASC 740-10/FIN 48
Accounting Standards Codification 740-10 (ASC 740-10), formerly referred to as Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), specifies a comprehensive model for how companies should determine and disclose in their financial statements uncertain tax positions (UTPs) that they have taken or expect to take on their tax returns. Existing guidance on the application of income-tax law is complicated and at times ambiguous; consequently, it is often unclear whether a particular position adopted on a tax return will ultimately be sustained or whether additional future payments will be required. As a result of limited specific authoritative literature on accounting for UTPs, significant diversity in practice has developed. This diversity in accounting raised concerns that tax contingency reserves had become susceptible to earnings' manipulations, and that company reserves could not reasonably be compared until standards for recording tax benefits were strengthened and standardised.

Under ASC 740-10, a company's financial statements will reflect expected future tax consequences of all UTPs. ASC 740-10 was effective as of the beginning of fiscal years that start after 15 December 2006. The estimation of tax exposure is to be retrospective as well as prospective. Tax reserves should be assessed under the assumption that taxing authorities have full knowledge of the position and all relevant facts. Each tax position must be evaluated on its own merits, without consideration of offsets or aggregations, and in light of multiple authoritative sources including legislation and intent, regulations, rulings and case law, as well as past administrative practices and precedents.

Two principles central to ASC 740-10 are recognition and measurement. The principle of 'recognition' means that a tax benefit from an uncertain position may be recognised only if it is 'more likely than not' that the position is sustainable under challenge from a taxing authority based on its technical merits, and without consideration of the likelihood of detection. Regarding 'measurement', ASC 740-10 instructs that the tax benefit of a UTP be quantified using a methodology based on 'cumulative probability'. That is, a company is to book the largest amount of tax benefit that has a greater than 50% likelihood of being realised upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

Because TP is a significant source of tax uncertainty, it must be considered in developing a tax provision. The existence of contemporaneous documentation covering a company's inter-company transactions is not sufficient to eliminate tax exposure uncertainty associated with those transactions. Often, the uncertainty associated with TP relates not to whether a taxpayer is entitled to a position but, rather, the amount of benefit the taxpayer can claim. The form and detail of documentation required to support a company's determination of its UTPs associated with TP will depend on many factors including the nature of the UTPs, the complexity of the issues under consideration and the materiality of the dollar amounts involved.

Coordination with Schedule UTP
The IRS has finalised Schedule UTP and instructions, which certain corporations will use starting with 2010 tax year to report UTPs as part of their US Federal income-tax filings. Additionally, with Announcement 2010-76, the IRS is expanding its policy of restraint in connection with its decision to require certain corporations to file Schedule UTP. A directive to LB&I personnel has also been issued setting forth the IRS's planned treatment of these UTPs by examiners and other personnel.

SEC Roadmap: Conversion of US GAAP to IFRS
In November 2008, the US Securities and Exchange Commission (SEC) released its proposed roadmap for the mandatory adoption of International Financial Reporting Standard (IFRS) in the United States. The proposed roadmap provided that US issuers adopt IFRS for financial reporting purposes as early as 2014, with the potential for voluntary adoption as early as 2009. Since this time, the mandatory US conversion date has been tabled indefinitely.

Transfer pricing controversy and dispute resolution

Tax audits
The IRS has extensive resources available to pursue field audits – at the appellate level and in CA procedures – including agents specially trained in economic analysis. Transfer pricing audits are not limited to cases where avoidance is suspected.

Multinational entities should expect to be called upon to affirmatively demonstrate how they set their inter-company prices and why the result is arm's length as part of the standard review of their US tax returns. Requests to produce supporting documentation within 30 days have become a standard feature at the commencement of such examinations.

Burden of proof
The administration of matters related to TP in the United States is based on the principle that the corporate income-tax system relies on self-assessment and that consequently the burden of proof is on the taxpayer.

Legal cases
There are a number of significant settled, decided and pending litigation matters involving TP issues in the United States. In the last decade the following three cases have attracted particular attention.

- GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner, 117 T.C. No. 1 (2001). The issue of development of marketing intangibles is at the core of the GlaxoSmithKline plc (Glaxo) Tax Court case. In September 2006, the IRS announced the resolution of the case, the largest tax dispute in the agency's history. The parties reached a settlement under which Glaxo agreed to pay the IRS approximately USD 3.4 billion. According to the IRS claims, drugs marketed by the UK multinational Glaxo through a US affiliate derived their primary value from marketing efforts in the United States rather than from R&D owned in the UK. The IRS's position is that the unique nature of the R&D may explain the success of the first drug of its kind; however, subsequent market entrants are successful primarily because of the marketing acumen of the US affiliate. Consequently, the IRS asserted that the rate Glaxo's US affiliate charged to its UK parent for marketing services was too low. Furthermore, it argues that the 'embedded' marketing intangibles, trademarks and trade names existed and were economically owned by the US affiliate. The IRS adjusted the transfer prices paid by the US affiliate to its parent to a contract manufacturing mark-up on costs and reduced the royalties paid by the US affiliate for the right to sell the product. Emphasising the US affiliate's contribution to enhancing the value of the intangibles, the IRS applied the residual PSM, resulting in a majority of the US affiliate's profits being allocated to the United States. Some tentative observations may be made as to what the implications of both the Glaxo case and the temporary regulations may be in the analysis of the use

of marketing intangibles for TP purposes. The approach proposed by the IRS under the temporary regulations (and the new services regulations), as well as in the Glaxo case, might in the future suggest greater reliance by the IRS on PSMs where a high value could arguably be attached to marketing services. With the heightened importance of these issues arising from a US perspective, tax authorities from other countries may also seek to employ a similar approach in determining the appropriate return for marketing and distribution functions performed by affiliates of foreign companies, especially where these issues are not contractually addressed by the parties.

- Veritas Software Corporation v. Commissioner, 133 T.C. No. 14 (2009). In Veritas, the IRS asserted that the taxpayer's calculation of the lump-sum buy-in payment for the transfer of intangibles between the taxpayer's US entity and its Irish entity was incorrect and determined tax deficiencies of USD 704 million and USD 54 million, and § 6662 penalties of USD 281 million and USD 22 million, relating to 2000 and 2001, respectively. In taking its very aggressive position with respect to the valuation of the transferred intangibles, the IRS relied extensively on the report and trial testimony of its expert economist. However, the report and trial testimony demonstrated a lack of understanding of the applicable law and cited regulations not in effect at the time of the transactions under review. The Tax Court found in favour of the taxpayer. The key lesson to be learned from this case is the importance of identifying and applying the relevant rules and regulations to the facts and circumstances at hand, given the IRS's targeting transactions involving the transfer of intangible property.
- Xilinx v. Commissioner, No. 06-74246 (9th Cir. Mar. 22, 2010). This extensively litigated case deals with the treatment of stock option costs in CSAs before the Temporary Regulations explicitly required the inclusion of these costs. In 2005, the US Tax Court rejected the IRS's assertion that the taxpayer had to include employee stock option deductions in the cost base of its CSA, despite the fact that unrelated parties acting at arm's length would not bear such costs. In May 2009, a three-judge panel of the 9th Circuit reversed the Tax Court. In January 2010, the 9th Circuit's ruling was withdrawn, apparently following a request for rehearing by the taxpayer. On rehearing the case, the same three-judge panel of the 9th Circuit reversed their earlier decision and sided with the taxpayer. The Xilinx case highlights the continued focus of the IRS on CSAs and the importance of documentation and calculation support by taxpayers.

Advance pricing agreements (APAs) and mutual agreement procedures (MAPs)

Reorganisation in 2012

In February 2012, the advance pricing agreement (APA) function was moved out of the IRS Office of Chief Counsel and combined with the IRS's Tax Treaty Office within the IRS's LB&I Division. This new, combined organisation was renamed the Advance Pricing and Mutual Agreement (APMA) programme. Designed to offer a more robust and effective platform for the resolution of TP issues, the new APMA organisation immediately launched a major hiring initiative, which attracted significant additional staff to the APMA organisation. Efficiencies between APA and CA were further strengthened by this reorganisation because the US CA, who derives his authority through delegation from the US Treasury Secretary, is the Deputy Commissioner (International), LB&I Division. As such, both programmes were effectively brought under one umbrella.

In 2012 – its first year of operation – the results produced by the APMA office indicated that the new organisation was fulfilling its promise. This trend continued in 2013 when the APMA programme executed a record high 145 APAs, an increase over the 140 executed in 2012, and after only 42 APAs were concluded in 2011, while the average time to complete APAs also decreased. Although auspicious, the 2012 mutual agreement procedure (MAP) statistics – the 2013 statistics not having yet been released at the time of this writing – do not reflect a similar sharp increase in resolutions over the prior year; instead, they reveal a 42% decline in the number of cases closed over the previous year. At the same time, processing time was significantly reduced with 2012 showing the lowest average time to close TP cases – the lowest average closing period in the past five years – and the percentage of total relief granted to taxpayers also increased. In 2012, approximately 96% of disputed amounts received correlative adjustments, or had adjustments withdrawn as compared with approximately 78% in 2011. Overall, these statistics demonstrate that the APMA is poised to provide the increased efficiencies and improvements to both the MAP and APA processes, which can benefit taxpayers and streamline tax administration by the IRS.

New revenue procedures proposed

On 22 November 2013, the IRS concurrently issued Notice 2013-78 and Notice 2013-79, proposing updated and revised revenue procedures for requesting CA assistance under US tax treaties and pursuing APAs, respectively. Anticipated since the establishment of the LB&I Division on 1 October 2010, and the consolidation of the APA programme into the Office of the CA effective 26 February 2012, these proposed revenue procedures both reflect the structural and organisational changes that precipitated them and signal the continued commitment and focus of the IRS on them as efficient avenues of proactive dispute resolution.

Key proposed changes

Although the process for requesting CA relief under US tax treaties is different in practice from that of pursuing an APA, there are key areas of convergence in terms of approach and intent between the two proposed revenue procedures.

Compulsory pre-filing conferences

Under current guidance, a pre-filing conference (PFC) in the context of both the APA and CA processes is optional and may be sought at the discretion of the taxpayer. Historically, PFCs have been informal and, in some cases, conducted on a no-name basis. The purpose of a PFC is to provide a constructive environment for the taxpayer and the IRS to evaluate the feasibility and appropriateness of the relief or assistance sought, given the taxpayers' facts and circumstances and the contemplated transactions. Generally, taxpayers use the PFC to seek clarification as to what functional and financial data the IRS will require as well as discuss potential issues that may be raised by a foreign tax authority – in the case of CA matters or bilateral or multilateral APAs – and the timing of the process.

Although the proposed revenue procedures would largely continue the existing PFC framework, certain other – more rigid – requirements would be introduced including, in certain cases, mandatory PFCs. In the context of both the APA and CA processes, PFCs would be required if the covered issues involve:

- a licence or other transfer of intangible property in connection with, or the development of intangible property under, an intangible development agreement

- a global trading arrangement, defined as any arrangement involving multiple associated enterprises that deal in securities or other financial products including ancillary activities, or
- unincorporated branches, pass-through entities, hybrid entities, or entities disregarded for US tax purposes.

In addition, PFCs would be mandatory for a taxpayer seeking a unilateral APA to cover an issue that otherwise is eligible for coverage by a bilateral or a multilateral APA, or for a taxpayer seeking to file an abbreviated APA request. In the CA arena, any taxpayer seeking US CA assistance regarding foreign-initiated adjustments totalling more than USD 10 million, all taxpayer-initiated adjustments and requests for discretionary limitation-on-benefits relief would require a PFC.

Increased disclosure requirements
Overall, the proposed revenue procedures significantly expand the information required by the IRS to pursue both APA and CA assistance.

Similar to the mandatory PFC requirements, US taxpayers would be required to submit a pre-filing memorandum (PFM) in the same instances in which a PFC also would be mandatory, such as when the covered issues involve intangible property, a global trading arrangement, entities disregarded for US tax purposes, or other specific issues. Where a PFM is mandatory, a taxpayer would not be able to submit such a document anonymously as was heretofore the case.

In addition to the procedural information typically requested as part of a PFC, an APA PFM would also be required to include 'covered issue diagrams', a new concept for the IRS. According to the proposed APA revenue procedure, covered issue diagrams must illustrate, "among other items, the legal structure, tax structure, business unit structure, inter-company flows, and value chain of the controlled group and proposed covered group". In the CA context, these diagrams would be included as part of the MAP request, although they are described in that proposed revenue procedure as 'similar to' rather than the same as those included in an APA PFM.

Beyond the upfront disclosure requirements, the total information sought by the IRS as part of both APA and CA submissions is also significantly expanded under the proposed revenue procedures. For example, on top of the data currently required as part of an APA submission, taxpayers under the new guidance would be mandated to provide the worldwide gross revenue of the controlled group including any business lines that are outside the scope of the proposed covered issue. The covered issue diagrams are also a critical part of the IRS's data gathering strategy with the guidance indicating that organisation charts identifying executive-level functional or occupational roles within the business units of the covered group – including the names of individuals in those positions and headcounts for the business units – must be included.

When MAP issues relate to matters arising under the business profits and associated enterprises' articles of US income-tax treaties, the proposed revenue procedure dictates the inclusion of the following items in addition to the equivalent of the covered issue diagrams specified in the proposed APA revenue procedure:

- A copy of TPD prepared, pursuant to IRC § 6662 or other documentation analysing the MAP issues for the years at issue.

- Financial data prepared for official statutory, regulatory, or other reporting purposes for the taxpayer's controlled group (whether the corporate parent is a US person or not) for the years at issue.
- Income statements and balance sheets, segmented as necessary to demonstrate the effect of the MAP issue(s) on taxable income, for the taxpayer and members of the controlled group for the years at issue.

The expansion of information required as part of both PFMs and the formal filings underscores the increased focus by the IRS on greater data collection and scrutiny of the related-party dealings of MNEs. Reflected also is the trend towards APMA personnel conducting more functional analysis interviews of key executives within a controlled group. The required information listed by the IRS seems to mirror the goals of recent international efforts by the OECD to move towards country-by-country reporting for TP purposes.

Mandatory rollback and roll forward

Under both current APA and MAP revenue procedures, a taxpayer may request either a rollback of an APA TP method to resolve the same TP issue in a prior tax year at any time during the APA process, or a roll forward of a MAP resolution through the Accelerated Competent Authority Procedure (ACAP), depending upon the type of intervention sought. In the case of APAs, the decision whether to grant such a rollback request rests with the field office with examination jurisdiction over the taxpayer, although the APMA office ultimately makes the final determination in a bilateral case as part of the bilateral mutual agreement process. With MAP resolutions, the IRS field office with jurisdiction over the matter must consent to ACAP.

Not dissimilar from the current revenue procedure, under the proposed guidance, a taxpayer would be encouraged to expand the scope of its APA request to include an APA rollback "when a comprehensive resolution of coverable issues would further the interests of sound tax administration". In an extension of the power afforded to APMA in the new revenue procedure, the proposed guidance states that "APMA may also condition its acceptance of an APA request upon the taxpayer's agreement to roll back … where APMA has clear interests in doing so and the taxpayers does not offer clear reasons against doing so". Whereas the APMA programme currently has no jurisdiction or delegated authority over non-APA years, this change would provide exactly that.

In parallel, the proposed MAP guidance also gives the US CA the ability to expand the scope of MAP cases unilaterally – without consent from either the taxpayer or the relevant IRS field office. In explaining the rationale for the change, the proposed revenue procedure states that the increased leeway on the part of the US CA serves the interest of 'resolving all potential MAP issues in a timely manner'. As such, the US CA will be able to 'initiate a MAP case in the absence of a MAP request' by the taxpayer and 'require that the scope of a MAP case be expanded'. Aside from including the ACAP years, the scope of MAP cases could be expanded also to include additional treaty countries, or additional MAP issues.

It is noteworthy that the proposed MAP revenue procedure does not specify the mechanism under which MAP cases will be required to expand their scope, but it is expected that the US CA will condition continuation of the MAP process on the taxpayer agreeing to the expanded scope. In a sign of the coordination between the MAP and APA processes, the proposed MAP revenue procedure also would encourage the taxpayer to include prospective years that would be covered under an APA. The

roll forward of MAP cases to include APA years is facilitated – under the proposed APA revenue procedure – by providing for abbreviated APA requests when the issues and circumstances surrounding the proposed APA years are 'reasonably expected to be substantially the same' as the factors surrounding the years covered by the MAP case.

Both the expansion of MAP cases – to include additional MAP issues and treaty countries – and the ability of the APMA programme to draw all relevant coverable issues into an APA request rely on the data made available through increased disclosure requirements to the IRS. Given that a driver for bringing APA and MAP together under the APMA programme was to encourage coordination and facilitate the exchange of information, the synchronisation of the proposed revenue procedures around increased information requirements is understandable.

The public comment period closed on 10 March 2014; final revenue procedures are expected to be issued soon thereafter.

Competent authority

The CA process may be invoked by taxpayers when they believe that the actions of the United States or another country with which the United States has concluded a tax treaty, or both parties, result or will result in taxation that is contrary to the provisions of a treaty (i.e. double taxation).

Taxpayers have the option of requesting CA assistance without first seeking a review of issues not agreed in the United States by the IRS Appeals Division. Issues may also be simultaneously considered by the US CA and the IRS Appeals Division. Competent authority agreements may be extended to resolve similar issues in subsequent tax years.

Under section 12 of the current revenue procedure, the limited circumstances in which the US CA may decline to take up the taxpayer's case with a treaty partner are enumerated. One such circumstance is if the taxpayer does not agree that CA negotiations are a government-to-government activity and they do not include the taxpayer's participation in the negotiation proceedings. Another is if the transaction giving rise to the request for CA assistance is a listed transaction under the US regulations as a tax avoidance transaction.

The scope of competent authority assistance

With the exception of the treaty with Bermuda, all US income-tax treaties contain a mutual agreement article that requires the competent authorities of the two treaty countries to consult with one another in an attempt to reduce or eliminate double taxation that would otherwise occur when the two countries claim simultaneous jurisdiction to tax the same income of an MNE, or an affiliated group.

The mutual agreement article contained in US tax treaties does not require the CAs to reach an agreement eliminating double taxation in a particular case. Rather, the treaties require only that the CAs make a good faith effort to reach such an agreement. Consequently, there is no guarantee that CA assistance will result in the elimination of double taxation in every case; however, in practice, the vast majority of cases are concluded with an agreement that avoids double taxation.

Competent authority negotiations are a government-to-government process. Direct taxpayer participation in the negotiations is not permitted. However, a taxpayer

may take a very proactive approach to CA proceedings, presenting directly to each government its view of the facts, arguments and supporting evidence in a particular case. The taxpayer can facilitate the negotiation process between the two governments by developing alternatives and responses to their problems and concerns.

Competent authority relief is most commonly sought in the context of TP cases, where one country reallocates income among related entities in a manner inconsistent with the treatment of the same transactions in the other country. In such cases, CA relief is intended to avoid double taxation by either eliminating or reducing the adjustment, or by making a correlative reduction of taxable income in the country from which income has been allocated. In TP cases, the US CA is guided by the § 482 regulations, but is not strictly bound by the regulations and may take into account all the facts and circumstances including the purpose of the treaty to avoid double taxation.

Other types of issues for which CA assistance may be sought include, inter alia, withholding tax issues, qualifications for treaty benefits and zero rate withholding for dividends and certain treaty interpretative issues.

When to request competent authority assistance

In the case of a US-initiated adjustment, a written request for CA relief may be submitted as soon as practical after the amount of the proposed IRS adjustment is communicated in writing to the taxpayer. For a foreign-initiated adjustment, CA assistance may be requested as soon as the possibility of double taxation arises. Once CA has been requested, the applicable treaty may provide general guidance with respect to the types of issues the competent authorities may address. These issues could be allocation of income, deductions, credits, or allowances between related persons, determination of the source and characterisation of particular items of income, and the common meaning or interpretation of terms used in the treaty.

Small case procedures

To be eligible for the small case procedure, the total proposed adjustments assessments must fall below certain specified amounts. Under the proposed revenue procedure, corporations and partnerships would qualify for this small case procedure if the proposed adjustments were not more than USD 5 million.

Statute of limitation protective measures

The statute of limitations or other procedural barriers under US or non-US law may preclude or limit the extent of the assistance available from the CAs. The US CA has generally sought to read into treaties a waiver of procedural barriers that may exist under US domestic law, even in the absence of specific language to that effect in the treaty. The same policy is not always followed by the US's treaty partners. Therefore, a taxpayer seeking the assistance of the US CA must take whatever protective measures are necessary to ensure that implementation of a CA agreement will not be barred by administrative, legal, or procedural barriers that exist under domestic law in either country.

In particular, the taxpayer must take steps to prevent the applicable statute of limitations from expiring in the other country. If a treaty partner declines to enter into CA negotiations, or if a CA agreement cannot be implemented because the non-US statute of limitations has expired, a taxpayer's failure to take protective measures in a timely fashion may cause the US CA to conclude that the taxpayer failed to exhaust its CA remedies for foreign tax credit purposes.

Some US treaties contain provisions that are intended to waive or otherwise remove procedural barriers to the credit, or refund of tax pursuant to a CA agreement, even though the otherwise applicable statute of limitations has expired. The current revenue procedure warns taxpayers not to rely on these provisions because of differences among treaty partners in interpreting these waiver provisions. The limits a treaty may impose on the issues the CA may address are also another reason for a taxpayer to take protective measures to ensure that implementation of a CA agreement will not be barred.

Most US treaties also contain specific time limitations in which a case may be brought before the applicable CAs. These time limitations are separate from the domestic statute limitations. For example, the treaty with Canada requires that the other country be notified of a proposed adjustment within six years from the end of the taxable year to which the case relates. This notification under the treaty can be accomplished, from a US perspective, by filing either a CA request pertaining to the proposed adjustments, or a letter requesting the preservation of the taxpayer's right to seek CA assistance at a later date, after administrative remedies in the other country have been pursued. If the latter course is followed, this letter must be updated annually until such time as the actual CA submission is filed or the taxpayer determines it no longer needs to protect its rights to go to the CA.

Unilateral withdrawal or reduction of US-initiated adjustments
Where the IRS has made a TP allocation, the primary goal of the US CA is to obtain a correlative adjustment from the foreign treaty country. Unilateral withdrawal or reduction of US-initiated adjustments, therefore, generally will not be considered. Only in extraordinary circumstances will the US CA consider unilateral relief to avoid double taxation.

Repatriation of funds following a transfer pricing adjustment
In 1999, the United States issued Revenue Procedure 99-32, which provided for the tax-free repatriation of certain amounts following a TP allocation to a US taxpayer, broadly with the intention of allowing the taxpayer to move funds to reflect the agreed allocation of income following the TP adjustment. In cases involving a treaty country, coordination with the US CA is required before concluding a closing agreement with the taxpayer.

The Revenue Procedure requires the taxpayer to establish an account receivable, which may be paid without any tax consequence, provided it is paid within 90 days of the closing agreement or tax return filing for the year in which the adjustment was reported. The following should be taken into account when establishing an account receivable:

- Absent payment of the account receivable within 90 days, the amount is treated as a dividend or capital contribution.
- The account receivable bears interest at an arm's-length rate.
- The receivable is deemed to have been created on the last day of the year, subject to the TP allocation, with the interest accrued being included in the income of the appropriate corporation each year the account receivable is deemed outstanding.

The Revenue Procedure the IRS previously issued in this area provided that previously paid dividends could be offset by the cash payment made in response to the primary TP adjustment. Under the 1999 Revenue Procedure, a taxpayer may only offset (i)

dividends paid in a year in which a taxpayer-initiated adjustment relates if offset treatment is claimed on a timely income tax return (or an amended tax return), or (ii) in the same year that a closing agreement is entered into in connection with an IRS-initiated adjustment. In the former case, the dividend is treated as a prepayment of interest and principle on the deemed account receivable.

Under the 1999 Revenue Procedure, relief is not available, however, with respect to transactions where a TP penalty is sustained. Effectively, this requirement imposes an additional tax for failure to maintain contemporaneous documentation to substantiate arm's-length TP. The US CA generally has no authority to negotiate or provide relief with respect to interest and penalties.

Advance pricing agreements (APA)

US procedures

The United States was the first country to issue a formal, comprehensive set of procedures relating to the issue of binding advance agreements dealing with the application of the arm's-length standard to inter-company transfer prices. Under the procedure, the taxpayer proposes a transfer pricing method (TPM) and provides data intended to show that the TPM is the appropriate application of the best method within the meaning of the regulations for determining arm's-length results between the taxpayer and specified affiliates with respect to specified inter-company transactions. The IRS evaluates the APA request by analysing the data submitted and any other relevant information. After discussion, if the taxpayer's proposal is acceptable, a written agreement is signed by the taxpayer and the IRS.

The procedures specify a detailed list of data that must be provided to the IRS with the application. There is also a user fee for participation in the programme, which currently ranges between USD 10,000 and USD 50,000, based on the size of the taxpayer and the nature of the request.

In the application, the taxpayer must propose and describe a set of critical assumptions. A critical assumption is described as any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business or economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume.

The taxpayer must file an annual report for the duration of the agreement, which will normally include:

- the application of the TPM to the actual operations for the year
- a description of any material lack of conformity with the critical assumptions, and
- an analysis of any compensating adjustments to be paid by one entity to another and the manner in which the payments are to be made.

The taxpayer must propose an initial term for the APA, appropriate to the industry, product or transaction involved, and must specify for which taxable year the agreement will be effective. The APA request must be filed no later than the extended filing date for the Federal income tax return for the first taxable year to be covered by the APA.

The effect of an APA is to guarantee that the IRS will regard the results of the TPM as satisfying the arm's-length standard if the taxpayer complies with the terms and conditions of the APA. The APA may be retroactively revoked in the case of fraud or malfeasance, cancelled in the event of misrepresentation, mistake/omission of fact, or lack of good faith compliance, or revised if the critical assumptions change. Adherence to the terms and conditions may be subject to audit – this will not include re-evaluation of the TPM.

Traditionally, the IRS APA procedures were limited to issues concerning TP matters in the context of section 482 of the Internal Revenue Code. However, effective 9 June 2008 the APA procedures (through Rev. Proc. 2008-31) were modified to expand the scope of the APA programme's purview to include other issues for which TP principles may be relevant including: 'attribution of profits to permanent establishment under an income-tax treaty, determining the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the US, and determining the amounts of income derived from sources partly within and partly without the US, as well as related subsidiary issues.' The expansion of the programme's scope may not necessarily translate into an immediate increase in the number of non-section 482 cases within the programme as the IRS has publicly indicated that it will be selective in the cases admitted into the programme. Nevertheless, the expansion of the programme's scope of review, providing for other non-section 482 issues that may be resolved through the APA process, is a welcomed development.

APAs for small business taxpayers and IRS-initiated APAs

In an effort to make the APA programme more accessible to all taxpayers, the IRS released a notice in early 1998, proposing special, simplified APA procedures for small business taxpayers (SBTs). The notice provides that a SBT is any US taxpayer with total gross income less than USD 200 million. Under the simplified APA procedures, the entire APA process is accelerated and streamlined, and the IRS will provide the SBT with more assistance than it does in a standard APA.

In an effort to streamline the APA process, the IRS may agree to apply streamlined procedures to a particular APA request, even if it does not conform fully to the requirements for 'small business' treatment.

The IRS has announced a programme under which district examiners are encouraged to suggest to taxpayers that they seek APAs, if the examiners believe that APAs might speed issue resolution.

Compliance assurance process (CAP) programme and transfer pricing

In May 2011, the IRS expanded and made permanent its six-year-old compliance assurance process (CAP) pilot programme for large corporate taxpayers. Under CAP, participating taxpayers work collaboratively with an IRS team to identify and resolve potential tax issues before the tax return is filed each year. With the major potential tax issues largely settled before filing, taxpayers are generally subject to shorter and narrower post-filing examinations. As a result of the CAP programme growing in popularity, it is being expanded to include two additional components. A new pre-CAP programme will provide interested taxpayers with a clear roadmap of the steps required for gaining entry into CAP. A new CAP maintenance programme is intended for taxpayers who have been in CAP, have fewer complex issues, and have established a track record of working cooperatively and transparently with the IRS. The CAP pilot began in 2005 with 17 taxpayers and in FY 2011 there were 140

taxpayers participating. Only taxpayers with assets of USD 10 million or more are eligible to participate. While participation in the CAP programme does not provide taxpayers with the same level of assurance as an agreed APA, it may be a means for large taxpayers to agree on TP matters ahead of the filing of the return and potentially minimise post-filing TP examinations.

Comparison with OECD Guidelines

The Best Method Rule

As noted in 'The US transfer pricing regulations' section, above, the US regulations require application of the Best Method Rule in the selection of a pricing method. The OECD Guidelines now refer to use of the 'most appropriate method', which in principle is very similar to the 'best method' described in the US regulations. A taxpayer does not necessarily have to examine each method in detail, but must take into account:

- the facts and circumstances of the case
- the evidence available, particularly in relation to the availability of comparable data, and
- the relative reliability of the various methods under consideration, which arguably continues to demonstrate some level of bias towards the use of transactional methods.

Comparability analysis

Both the US regulations and the OECD Guidelines provide that the arm's-length character of an inter-company transaction is ordinarily determined by comparing the results under the regulations or the conditions under the Guidelines (i.e. in both cases meaning either prices or profits) of that controlled transaction to the results realised or conditions present in CUTs. Comparability factors that must be taken into account include functions performed, risks assumed, contractual terms and economic conditions present, and the characteristics of the property transferred, or the services provided. Determination of the degree of comparability must be based on a functional analysis made to identify the economically significant functions performed, assets used, and risks assumed by the controlled and uncontrolled parties involved in the transactions under review.

Both the US regulations and the OECD Guidelines permit the use of inexact comparables that are similar to the controlled transaction under review. Reasonably accurate adjustments must be made to the uncontrolled comparables, however, to take into account material differences between the controlled and uncontrolled transactions if such adjustments will improve the reliability of the results obtained under the selected pricing method. Both the US regulations and the OECD Guidelines expressly prohibit the use of unadjusted industry average returns to establish an arm's-length result.

An important comparability factor under both the US regulations and the OECD Guidelines is the allocation of risk within the controlled group. The types of risks that must be taken into account under both sets of rules include: market risks; risk of loss associated with the investment in and use of property, plant and equipment; risks associated with the success or failure of R&D activities; and financial risks such as those caused by currency exchange rate and interest rate variability. In addition, under both sets of rules the determination of which party actually bears a risk depends, in

part, on the actual conduct of the parties and the degree to which a party exercises control over the business activities associated with the risk.

Market penetration strategies
Consistent with the US regulations, the OECD Guidelines recognise that market penetration strategies may affect transfer prices. Both the regulations and the Guidelines require that where a taxpayer has undertaken such business strategies, it must be shown that:

- there is a reasonable expectation that future profits will provide a reasonable return in relation to the costs incurred to implement the strategy, and
- the strategy is pursued for a reasonable period of time, given the industry and product in question.

The OECD Guidelines are generally less restrictive concerning market penetration strategies than the US regulations, which require a very extensive factual showing and documentation.

Arm's-length range
Similar to the US regulations, the OECD Guidelines provide that no adjustment should be made to a taxpayer's TP results if those results are within an arm's-length range. The Guidelines do not include specific rules for establishing the arm's-length range, but do recognise that the existence of substantial deviation among the results of the comparables suggests that some of the comparables may not be as reliable as others, or that significant adjustments to the results of the comparables may be necessary.

What has to be at arm's length? Setting prices versus evaluating the result
The primary focus of the US regulations is on whether a taxpayer has reflected arm's-length results on its US income tax return; the actual methods and procedures used by taxpayers to set transfer prices are not relevant. The OECD Guidelines, however, tend to focus less on the results of TP and more on whether the transfer prices were established in an arm's-length manner substantially similar to the manner in which uncontrolled parties would negotiate prices. Consequently, the Guidelines put significant emphasis on factors known by the taxpayer at the time transfer prices were established.

Traditional transactional methods
As noted above, the OECD Guidelines express some level of preference for the use of traditional transaction methods for testing the arm's-length character of transfer prices for transfers of tangible property. These methods include the CUP method, the RPM, and the CP method. These same methods are 'specified methods' under the US regulations.

Under both the US regulations and the OECD Guidelines, the focus is on the comparability of products under the CUP method, and the comparability of functions under the resale price and CP methods. Under all three methods and under both sets of rules, comparability adjustments must take into account material differences in operating expenses, accounting conventions, geographic markets, and business experience and management efficiency.

There are no material substantive differences between the US regulations and the OECD Guidelines in the theoretical concepts underlying these methods, the manner in which these methods are to be applied, or the conditions under which these methods would likely be the best method.

Other methods
Both the US regulations and the OECD Guidelines provide for the use of other methods when the traditional transaction methods cannot be used. Under the US regulations, a taxpayer may use the CPM or the PSM. Under the Guidelines, a taxpayer may use the PSM or the transactional net margin method (TNMM). In most cases, as explained below, the CPM and the TNMM are virtually indistinguishable. The emphasis on comparability throughout the US regulations, however, is intended to limit the use of PSMs to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable comparables under some other method. The Guidelines, on the other hand, express a strong preference for the use of the PSM over the TNMM.

Transactional net margin method (TNMM)
The TNMM compares the operating profit relative to an appropriate base (i.e. a profit level indicator [PLI]) of the controlled enterprise that is the least complex and owns no valuable intangibles (i.e. the tested party) to a similar measure of operating profit realised by comparable uncontrolled parties in a manner consistent with the manner in which the resale price or CP methods are applied. The operating rules for the TNMM are, as a result, substantially the same as those for the CPM. Both methods require that the analysis be applied to an appropriate business segment and use consistent measures of profitability and consistent accounting conventions.

The OECD Guidelines do require that the TNMM be applied on a transactional basis. The precise meaning of this requirement is not clear. It will ordinarily not be possible to identify net profit margins of comparables on a truly transactional basis, and in many cases, taxpayers will have difficulty identifying their own net profits on a transactional basis. In any event, it appears that the TNMM is intended to be applied in the same manner as the resale price and CP methods, which ordinarily look to overall gross margins for an entire business segment for the full taxable year. Presumably, the TNMM should be applied in the same manner.

The OECD Guidelines, as a result, do not prohibit the use of the CPM. They do provide, however, that the only profit-based methods such as the CPM and so-called modified resale price/cost-plus methods that satisfy the arm's-length standard are those that are consistent with the TNMM.

Intangible property
In respect to the treatment of intangible property, the OECD issued a chapter discussing the special considerations arising under the arm's-length principle for establishing TP for transactions involving intangible property which will be revised in the near future. The OECD places emphasis on the actions that would have been taken by unrelated third parties at the time the transaction occurred. The Guidelines focus on the relative economic contribution made by various group members towards the development of the value of the intangible and on the exploitation rights that have been transferred in an inter-company transaction. This is particularly true in the case of the pricing of marketing intangibles. The Guidelines consequently focus on economic ownership of the intangible as opposed to legal ownership.

The OECD Guidelines do not provide significant new guidance for the pricing of intangibles by providing specific standards of comparability. The Guidelines, similar to the US regulations, provide that prices for intangibles should be based on:

- the anticipated benefits to each party
- prior agreement on price adjustments, or short-term contracts, or
- the allocation of the cost or benefit of uncertainty to one party in the transaction, with the possibility of renegotiation in the event of extreme or unforeseen circumstances.

The only pricing method that is specifically approved is the CUP method, which is equivalent to the CUT method in the US regulations. The Guidelines give a cautious endorsement to the use of the PSMs or the TNMM, when it is difficult to apply a transactional method. This is not inconsistent with the outcome that would be expected if the US Best Method Rule were applied in the same circumstances except for the preference of the PSM over the TNMM.

The redefining of the intangible property (IP) ownership rules for non-legally protected intangibles under the proposed regulations will likely attract much debate between the United States and its treaty partners who have adopted the OECD Guidelines on this matter. Uncertainties in the definition of 'practical control' and 'economic substance' will be the main drivers of such potential disputes.

Periodic adjustments under the OECD Guidelines

The main area of potential difficulty arises from the focus in the US regulations on achieving an arm's-length result. There is a very evident potential for dispute as to whether the concept of periodic adjustments under the US regulations (described above) is at odds with the statements in the Guidelines concerning the use of hindsight. However, the OECD Guidelines clearly affirm the right of tax authorities to audit the accuracy of the forecasts that were used to establish TP arrangements, and to make adjustments if the projections on which the pricing was based, prove to be inadequate or unreasonable.

Services

Both the US regulations and the OECD Guidelines focus on satisfying the arm's-length standard by the recharge of costs specifically incurred by one group member to provide a service to another group member. Under both the US regulations and the Guidelines, costs incurred include a reasonable allocation of indirect costs.

As to whether the arm's-length charge for services also includes a profit to the service provider, the Guidelines state that the inclusion of a profit margin is normally part of the cost of the services. In an arm's-length transaction, an independent enterprise would normally seek to charge for services in such a way as to generate a profit. There might be circumstances, however, in which an independent enterprise may not realise a profit from the performance of service activities alone. For example, the services provider might offer its services to increase profitability by complementing its range of activities.

The proposed regulations (on Services) are intended to conform the US regulations to the OECD Guidelines by eliminating the cost safe harbour method for non-integral activities. However, this intention is partially negated with the proposal of the elective services' cost method for certain types of activities deemed 'low margin' services ().

Documentation and penalties
The OECD Guidelines recommend that taxpayers make reasonable efforts at the time TP is established to determine whether their TP results meet the arm's-length standard, and they advise taxpayers that it would be prudent to document those efforts on a contemporaneous basis. The Guidelines also admonish tax authorities to balance their needs for taxpayer documentation with the cost and administrative burden imposed on taxpayers in the preparation of that documentation. The Guidelines also note that adequate record-keeping and voluntary production of documents facilitates examinations and the resolution of TP issues that arise.

The OECD Guidelines include a cautious acknowledgement that penalties may play a legitimate role in improving tax compliance in the TP area. The Guidelines encourage member countries to administer any such penalty system in a manner that is fair and not unduly onerous for taxpayers.

103.

Uruguay

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Overview

In Uruguay, transfer pricing (TP) continues to be an area of focus for the Uruguayan General Tax Bureau (GTB). More work has been seen in the TP area as the GTB is more sophisticated and has greater experience. Since the 2011 audits, special attention is being placed on companies with low margins and transactions structured through international traders, especially if these transactions involve commodities with internationally known market prices and cases of business restructurings. The GTB is open to subscribe advance pricing agreements (APA).

Country	**Uruguay**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Explicitly not but regulations conceptually follow some of them.
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Only with low/nil-tax regimes.
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	9th month after fiscal year-end. TP adjustment prior to the filing of the corporate income tax return (4 months after fiscal year-end).
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes

Uruguay

Country	Uruguay
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	A fine of 20% and interest on underpaid tax. Formal duties up to approx. 230,000 United States dollars (USD).

Introduction

In 2007, Uruguay implemented a significant and historical tax reform pursuant to approval of Law 18.083, which incorporated, among other concepts, the personal income tax that had been repealed in the early 1970s, the figure of permanent establishment (PE) and the concepts of residence and TP. Notwithstanding, the source principle has been maintained as the basic taxability empowerment criteria.

This law was enacted by the executive power on 27 December 2006, and was published in the Official Gazette on 18 January 2007.

Until 2007, Uruguayan tax legislation had not given a general legal solution for the issue of TP, except for certain provisions included in the regulations of business income tax relating to export or import transactions involving merchandise and some other specific rulings. Regarding export and import transactions, Article 21 of Title 4 of the 1996 Coordinated Tax Compilation (CTC) and related detailed regulations contained in Article 19 of Decree 840/988 prescribe consideration of the wholesaler's price plus certain other connected charges for determining the net income of a local source related to all export and import transactions made by an enterprise (without differentiating between a related party or a third party). This ruling extends to transactions made between Uruguayan free zones and non-free zone territory, as stated in Article 8 of Decree 733/991.

Law 18.083 incorporates for the first time a specific chapter (Chapter VII of Title 4 of the 1996 CTC) on TP under the regulations of Income Tax on Economic Activities (ITEA or IRAE as per Uruguayan abbreviation in Spanish), which are in force for fiscal years commencing 1 July 2007, and onwards.

On 26 January 2009, the regulatory decree was issued (Decree 56/009), containing detailed regulations on the TP regime. Later, on 24 August 2009, a second decree (Decree 392/009) was issued clarifying some of those regulations. The regulations of this decree, establishing obligations or burdens for the taxpayer, will come into force for operations commencing in fiscal years starting from 1 January 2009 and onwards.

In December 2009, the GTB, in agreement with the Finance Ministry, issued Resolutions 2084/009 and 2269/009, providing further details about certain aspects of the existing TP regulations.

Several binding consultations regarding TP matters were published by the GTB since TP rules came into force. .

Legislation and guidance

As a general principle, the regulations on TP are applicable to international transactions made between related parties. However, Uruguayan legislation has extended the scope of these regulations to transactions carried out with low-tax or nil-tax jurisdictions or regimes (either international or domestic) and certain operations through third intermediaries.

Transactions between related parties

Law 18.083 states that transactions between IRAE taxpayers and related parties or individuals will be deemed arm's length for all purposes when the terms and conditions (T&C) provided therein are in conformity with normal market practices between independent parties, without prejudice to the cases of existing limitations for expense deductions upon computing net taxable income.

In principle, according to the law, the burden of proving that the aforementioned T&C are not in conformity with market values falls on the GTB, except in the case of transactions performed by the IRAE taxpayer with companies in low-tax or nil-tax jurisdictions, or regimes that are absolutely presumed not to be arm's length.

However, the documentation requirements imposed by the GTB have, in fact, transferred such burden to the taxpayer.

Related parties

The definition adopted by the law for related-party status is quite broad. Such a relationship is configured when both parties are subject – directly or indirectly – to the management or control of the same individuals or legal entities, or when they have the power of decision to direct or define the taxpayer's activities, due to their participation in capital interest, or the level of their credit rights or their functional or any other type of influence (whether contractual or not).

The law expressly states that operations undertaken by taxpayers with foreign affiliates, branches, PEs or any other kind of foreign non-resident entities related thereto will be subject to the same principle.

Resolution 2084/009 provides an in-depth description of the circumstances under which a company will be deemed a related party. For the GTB, and without prejudice to other situations, the related-party status will be deemed configured when transactions are made between the parties and one of the assumptions detailed below is in existence:

- An entity has an equity interest of 10% or more in the capital of another entity.
- An entity exercises its functional influence on the other entity.
- Two or more entities have, indistinctly:
    - Another common entity jointly possessing an equity interest of 10% or more in the capital of each of the above.
    - Another common entity jointly possessing an equity interest of 10% or more in the capital of one or more entities, together with functional influence on one or more of the other entities above.
    - Another common entity possessing functional influence simultaneously on each of the other entities above.

- An entity holding the voting rights as necessary to determine the decision-making of the other entity or to prevail on the competent decision-making body of the other entity.
- Two or more entities having an entity in common that holds the voting rights as necessary to determine the decision-making of the other entity or to prevail on the competent decision-making body of those two or more entities.
- When the main business activity of an entity is derived from exclusivity contracts as agent, distributor, concessionaire or supplier of goods, services or rights, subscribed with another entity (to these effects, it will be considered that a business activity will qualify as the principal activity, when the level of income generated by the same represents at least 50% of the total revenue obtained by the entity during the corresponding financial year).
- An entity participating in fixing policies in the areas of business, procurement of raw materials, production or marketing and trading of the other entity.
- Two or more entities having a common entity jointly participating in fixing policies in the areas of business, procurement of raw materials, production or marketing and trading of those two or more entities.
- An entity taking charge of the losses or expenses of another entity.

The GTB also describes some situations in which the 'functional influence' is deemed to be in place, whenever:

- Two or more entities have common directors, managers or other staff members holding decision powers to provide guidance or to define the activities of the entities.
- An entity provides to the other entity proprietary technology or technical knowledge that constitutes the basis for the activities of the latter.
- Two or more entities agree to contractual clauses that assume a preferential nature in comparison with those granted to third parties under similar circumstances, such as volume discount arrangements, financing for transactions or delivery on consignment.
- An entity develops significant activities only in relation to the other entity, or its existence is justified only in relation to the other entity, giving rise to situations such as being the sole supplier or sole client.
- An entity provides substantially the funding required for the business activities of the other, by means of granting loans and submitting guarantees of whatever type in the case of financing provided by a third party.
- The directors, managers, or other staff holding decision powers in an entity receive instructions from the other entity or act in the interest of the latter.
- There are agreements, circumstances or situations whereby the management of an entity is entrusted to an entity holding a minority capital interest in the first entity.

Countries or regimes with low taxation or nil taxation

The operations undertaken by taxpayers with countries or regimes with low or nil taxation will be perceptively treated as related parties (without admitting proof to the contrary) and will be considered as not being in conformity with normal market practices or values between independent parties.

The following operations are included in this category:

- Transactions with non-residents domiciled, organised or located in countries of low or nil taxation.
- Transactions with non-residents who are beneficiaries under a special regime of low or nil taxation.
- Transactions carried out with entities operating in customs' areas (including those within Uruguayan territory) and benefitting from a regime of low or nil taxation; consequently, transactions with entities operating in such areas (e.g. Uruguayan or foreign free zones) would fall under this category.

The countries and regimes referred to in the first two cases above were enumerated specifically in Decree 56/009 (33 countries or jurisdictions were listed). Regarding operations referred to in the third case above, Decree 392/009 defined the concept of 'customs' areas' that benefit from a 'regime of low or nil taxation'. Customs' areas comprise the free zones, free ports and other geographic areas where customs' regulations are not applicable, located either in Uruguay or abroad. Regimes of low or nil taxation are defined as those having an effective income tax rate lower than 40% of the IRAE rate (i.e. when such effective income tax rate is lower than 10%, equivalent to 40% of 25%). It must be noted that some of these operations are excluded from the TP regime when they comply with certain requirements.

Operations through intermediaries

Imports and exports' transactions under the intervention of an international intermediary other than the final recipient of the goods are subject to TP rules when:

- there is a related-party connection between the local operator and the international intermediary, either by virtue of the general related-party assumptions established by law or of non-compliance with certain requirements stated by law (if these requirements are not met, the intermediary would be considered a related party), or
- there is a related-party connection between the local operator and the effective recipient of the goods (whether or not the intermediary complies with such requirements).

Methodology

Law 18.083 adopts the best accepted international methodologies and requires use of the most appropriate method according to the type of transaction performed.

The law foresees the application of the following five methods, apart from others that may be established in the detailed regulations:

- Comparable uncontrolled price (CUP) method
- Resale price method (RPM)
- Cost plus (CP) method
- Profit split method (PSM)
- Transactional net margin method (TNMM).

Decree 56/009 adopts such methods and defines them.

Tested party
When applying the methods, the analysis of comparability and justification of the transfer prices can be made indistinctly on the situation of the local entity or of the foreign entity. Should the option adopted be to analyse the position of the foreign subject, due documentary proof will be required, which should be certified in the foreign subject's host country by an independent auditor of recognised reputation, duly translated into Spanish and legalised.

Comparability factors
In accordance with Decree 56/009, the comparability factors include, among others:

- characteristics of the transactions
- functions or activities including assets engaged and risks assumed in the transactions of each of the parties involved
- contractual terms, and
- economic circumstances.

The regulatory decree does not mention 'business strategies' as one of the factors determining comparability. However, the elements and circumstances referred to in the decree are not stated in a restricted sense. In this case, an in-depth analysis is recommended.

Exception to the most appropriate method rule
The law prescribes perceptive application of the CUP method in the following cases:

- Imports and exports of goods with related parties for which a public and notorious international price known in transparent markets can be determined (commodities), in which case such prices should be used, unless there is proof to the contrary.
- Imports and exports of goods through a foreign intermediary other than the final recipient of the goods.

These represent transactions between related parties involving primary farming products and, in general, goods knowingly quoted in transparent markets (commodities); in this case the price applied should be the value quoted in such market at the date the goods are laden, regardless of means of transportation or the price agreed upon with the intermediary. According to the law, this method will not be enforced when the taxpayer is able to provide trustworthy evidence that the intermediary fully complies with the following requirements:

- It has a residence abroad and actual presence in the foreign territory, having a commercial establishment in such location for managing its business activities and complying with the legal requisites of constitution, registration and filing of financial statements. The assets, risks and functions assumed by the intermediary should be appropriate to the volume of business transactions made.
- Its main activity should be different from generating passive revenue or intermediation in the trading of goods out of, or into, Uruguay, or with other members of the group economically related to the intermediary.
- Its international trade transactions with other subjects related to the importer, or exporter in the case, should not exceed 30% of the annual revenue from transactions made under its intervention.

However, as it was mentioned above, Decree 392/009 states that the operations included in case 2 above comprise all imports and exports' transactions made under the intervention of an international intermediary, provided any of the following situations take place:

- Existence of a related-party connection between the local operator and the international intermediary, either by virtue of the general related-party assumptions established by law or of non-compliance with the three requirements mentioned above.
- Existence of a related connection between the local operator and the effective recipient of the goods as established by law, even when the intermediary complies with the three requirements mentioned above.

The GTB may extend the application of this method to comprise other international transactions with the participation of an intermediary other than the final recipient of the goods, provided the GTB is able to produce trustworthy evidence proving that the intermediary is not in compliance with the aforementioned requirements.

For this purpose, in the case of import transactions, the price will be the higher of the prices quoted in a transparent market of recognised international prestige, if the price agreed upon with the related party is still higher. In the case of export transactions, the lower quoted price will be applied if the agreed-upon price is lower. The quoted price may be reasonably adjusted to the value of the merchandise to the point of local market, in respect of the insurance and freight costs involved.

According to Decree 392/009, in either case 1 or 2 above, if the contract has been registered, the price applied should be the quoted price prevailing as of the date of the contract. If the contract has not been registered, such quoted price will be applied as of the date of the corresponding bill of lading.

The Uruguayan Products Mercantile Chamber is the institution appointed as the registry office of such contracts. This registration will be optional for the taxpayers and will be opposable to the GTB when such registration is made within five working days of the month following execution of the contract.

Arm's-length range

When two or more comparable transactions are identified, the median and the interquartile price ranges should be determined for the amount of the consideration or the profit margins involved.

Should the price or profit margin fixed by the taxpayer fall within the interquartile range, such price and profit margin will be deemed as having been agreed upon between independent parties.

Otherwise, it will be deemed that the price, amount of the consideration or profit margin that would have been applied by independent parties is the one that corresponds to the median reduced by (or plus) 5%, depending on the transactions under analysis.

Other regulations

Optional regimes of notional profit assumptions

Law 18.083 empowers the executive power to establish special notional profit regimes (safe harbours) considering the modus operandi of the transactions and of the type of business activity or exploitation. Such regimes will be optional and for the purpose of determining the income source of those transactions subject to regulations on TP.

The GTB may establish a special regime for determining notional profits derived from import or export operations concerning goods for which a notorious international price in a transparent market can be determined. This regime will be optional and applicable during a period of no more than three years (counted for fiscal years closing after the date the regime comes into force).

The rule of wholesaler's price as residual criterion

In the case of import and export operations not contemplated in Chapter VII of Title 4 of the 1996 CTC in connection with TP, the Uruguayan source income will be determined considering the free on board (FOB) or the cost, insurance and freight (CIF) value of the goods being imported or exported.

However, when no price has been fixed or when the price stated does not conform to prices prevailing in the international market, such income will be determined in the form to be established in the detailed regulations.

Such detailed regulations adopted the criteria followed to date in connection with the wholesaler's price rule. Such price will be the wholesaler's price prevailing in the place of origin of the goods (in the case of imports), or in the place of destination (in the case of exports), plus certain comparability adjustments. Should this price not be known to the public, or should there be doubts about its applicability to the same, or to similar, goods being imported or exported, or some other reason hindering comparison, the Uruguayan source income will be calculated, taking into account profit ratios obtained from independent enterprises engaged in identical or similar activities.

Operations between head offices and permanent establishments

Decree 572/009 regulates transactions executed between head offices, regarding different aspects, such as expenses incurred abroad, the determination of income distribution between head offices and PEs and the withholding tax regime.

Expenses incurred abroad

Expenses incurred abroad by non-resident entities in order to generate and preserve the income obtained by a Uruguayan source of a PE will be admitted as long as they are necessary for those purposes and provided that reliable proof can be produced in order to justify their origin and nature. The same treatment will apply to such expenses made by a PE located abroad in favour of the head office located in Uruguayan territory and between PEs of the same head office, located abroad or in Uruguayan territory.

Attribution of income between head offices and PEs

The net income generated by PEs of entities not residing in Uruguay will be determined on the basis of the separate accounting records. It might be necessary to make some adjustments in order to assess the real profits of these establishments. The same criteria would be applied in cases in which the head office resides in Uruguay and the entity's PE resides abroad. If the accounting records fail to accurately reflect the income generated by the Uruguayan source, the GTB will perform an administrative

assessment of such net income for tax purposes. The business turnover and other appropriate indicators may be used to perform such task.

To these effects the head office or PE will be attributed the income it might have derived had it been a distinct and separate enterprise engaged in identical or similar activities in the same or analogous conditions and operating with total independence from the enterprise of which it is a PE or head office (confirming the arm's-length principle).

It must be taken into consideration that PEs of non-resident entities must compute (from a tax point of view) all income obtained in the country by the foreign entity (except certain cases).

Ratification of the arm's-length principle
Transactions made by a PE with its head office are deemed to be made between parties that are economically and judicially independent, provided their considerations and conditions are in line with normal market practices between independent entities. The same treatment will be applied for transactions made between PEs with the same head office, which are located in a Uruguayan territory and abroad.

WHT regime
The transactions between a PE and its head office or with other foreign PEs will be subject to the general WHT regime.

Management services
Law 18.083 does not include special regulations on the treatment of management services in the area related to TP. The methodology proposed by the law, and then defined by the regulatory decree, should be applied to operations of any kind.

Payments abroad for the concept of management services are tax-deductible, provided they are accrued in the fiscal year under analysis, are necessary for the generation of Uruguayan-source income, are duly documented, and are taxable under the income tax on non-residents or under an effective income taxation imposed abroad. Should they be levied under those taxes at an overall rate of less than the Uruguayan income tax on economic activities rate (i.e. 25%), their deduction will be proportional.

Penalties
Specific penalty provisions for TP were established in November 2012.

The implementation of the new legislation in 2012, in force since January 2013, implies aggravation of stipulated penalties for the non-compliance of IRAE taxpayers' formal duties, which, depending on the seriousness of the breach, may result in being a thousand times the maximum fine for contravention. The current maximum fine for contravention, established in Decree 359/014, is 6,090 Uruguayan pesos (UYU), whereby the maximum amount of fine which the Tax Administration could claim rises to UYU 6,090,000 (approximately USD 230,000). As well as IRAE taxpayers who are required to submit the TP study, it should be noted that the other subjects included in the TP regime are also required to analyse operations performed, and shall keep their tax receipts justifying the price and comparison criteria used. Therefore they, in the light of the new regulation, should conserve these documents.

Moreover, when a taxpayer is in default, a fine of 20% of the tax underpaid and interest will be charged on such tax underpaid, calculated from the original due date. In some cases, this fine can be reduced. The rates at which this interest accrues are published, but in general they are close to, but higher than, ordinary bank rates.

Examples of more severe sanctions include tax fraud both as an infringement (punished with a fine of between one and fifteen times the amount of the fraudulent tax omission or attempted omission) and as a criminal act (subject to an imprisonment penalty of between six months and six years). In both cases, the behaviour, subject to punishment is configured by deceit or deceitful concealment with the purpose of creating an undue fiscal benefit.

Any interest or penalties paid are not tax-deductible.

Documentation

Although the law per se does not require mandatory preparation of formal TP documentation, it does provide that both the administration and the detailed regulations may require additional information for purposes of control and tax audit. The regulatory decree states that the taxpayers determined by the GTB must file special tax returns in the form established by this authority. The GTB may require them to file the vouchers and other documentary evidence supporting the transfer prices as well as the comparison criteria used to analyse due application of the prices, amounts of the considerations or profit margins reported in such special tax return.

According to Resolution 2084/009, taxpayers will be required to file annual information if they meet any of the following conditions:

- Their transactions subject to TP rules are in excess of 50 million indexed units (equivalent to approximately USD 5.5 million).
- They have been notified for filing by the GTB.

The information referred to above will have the following contents:

- Informative tax return stating the details and amounts of transactions of the period subject to the TP regime.
- Copy of the financial statements for the fiscal period, if not submitted previously in compliance with other regulations.
- Transfer pricing study (with a minimum content).

The TP study must cover the following aspects, as a minimum:

- Description of the activities and functions developed.
- Description of the risks assumed and the assets used in performing such activities and functions.
- Description of the elements, documentation, circumstances and facts considered for the study.
- Description and quantification of the transactions included in the TP regime.
- Identification of the counterpart entities of the transactions included in the TP regime.

- Methodology selected for determining the price of the transactions, stating the reasons and bases to justify it was the most appropriate method, as well as the reasons for discarding the methods set aside.
- Identification of each of the comparables selected for justifying the transfer prices used.
- Identification of the sources of information on such comparables.
- Detail of comparables selected initially and discarded later, indicating the reasons considered for this action.
- Quantification and methodology used for making the adjustments required to the comparables selected.
- Determination of the median and the interquartile range.
- Description of the business activities and characteristics of the enterprise, and of other elements relevant to the comparable entities.
- Conclusions derived from the study.

The filing deadline for this documentation will be nine months after the closing date of the fiscal year.

Resolution 2084/009 states that taxpayers who are not required to file the annual information referred to above must still keep on file the vouchers and other supporting evidence justifying the transfer prices used and the comparison criteria applied during the period of limitations of taxation in order to duly demonstrate and justify the correct determination of those prices and the amounts of the considerations fixed or the profit margins declared.

Use and availability of comparable information
Following the Organisation for Economic Co-operation and Development (OECD) Guidelines, the use of comparable information is essential for any analysis concerning the TP issue.

Regarding local financial information, enterprises are obliged to file their financial statements with the Registry of the National Internal Audit Bureau only when they show total assets in excess of the equivalent of USD 900,000 at the financial year end or net operating revenue during that year in excess of the equivalent of USD 3 million. While this information is available for any interested party, its usefulness as a potential comparable is subject to the degree of detail of such information.

For tax purposes, financial statement of large and medium size companies (as per the classification of the GTB) must be accompanied by an audit or review report, issued by a Uruguayan Certified Public Accountant. Law 18.996 enacted on November 2012, empowers the GTB to suspend the annual tax certificate validity when taxpayers fail to file their financial statements to the National Internal Audit.

This measure enlarges the number of independent companies in the local market enabling their use as local potential comparables.

Transfer pricing controversy and dispute resolution

Burden of proof

As a rule, the burden of proof lies with the GTB unless the operations involve countries or regimes of low or nil taxation.

The law presumes that transactions with related parties are made at market values, unless the GTB can provide trustworthy proof that the transactions have not been priced at such values. Conversely, in the case of transactions with countries or regimes of low or nil taxation (either domestic or international), the law presumes that such transactions do not comply with the arm's-length principle and therefore should be adjusted.

However, taking into account the TP documentation requirements, taxpayers should endeavour to show that their determinations of TP are consistent with the arm's-length principle, regardless of where the burden of proof lies. In fact, the burden of proof would be transferred to taxpayers.

Tax audit procedures

The GTB launched intense tax audit proceedings, focused within the large taxpayers division.

Although the new regulations on TP were not applicable until 2007, before that date there were cases in which the GTB set forth its allegations questioning the structures adopted by the taxpayers, on the basis of current regulations on 'economic substance'. Many of these cases were closed under mutual agreement with the GTB, with the corresponding tax amounts being restored along with related fines and interest charges. In some of the cases, the administration had accepted presentation of the documentation on TP studies as a form of justifying the pricing policy adopted by the taxpayer in the structures used.

During 2010, the GTB formed a specialist TP team, which as of that date has been actively performing TP audits.

Tax audits are carried out by the audit department of the GTB after tax returns are filed. Tax audits are carried out on a sampling basis; therefore, from the taxpayer's perspective, they are unpredictable. Tax audits start with a formal communication of the inspection. A request for information setting forth a series of questions is delivered to the taxpayer.

As a general rule, the taxes are self-assessed by the taxpayer, but the GTB has far-reaching authority for fiscal investigation and verification. For example, the GTB may require taxpayers to show their books and records including documentation files and business correspondence, either of their own or kept for third parties; require the taxpayer's appearance at the administration's authority to provide information; or perform tax audits of real estate and chattel properties held or occupied by the taxpayer.

The proceedings are in writing, both for the presentations made by the taxpayer and the tax auditor. These are documented in minutes, which should be signed by both parties.

Regarding TP, it must be noted that the GTB may use the information obtained in its audit as 'secret comparables'. Expressly, the law states that the tax secrecy rule set in force as a general principle in the tax code will not apply to the information related to third parties that might be necessary for determining the transfer prices, whenever the administration needs to submit such information as proof before the court or in administrative proceedings (*see Resources available to the tax authorities*).

Revised assessments and the appeals procedure

Once the circumstances giving rise to the tax obligation take place, the administration makes its tax assessment through an Act of Determination, which may be appealed by the taxpayer within a term of ten days after the date the respective notification is served.

The resources available for the taxpayer are: the Appeal for Reversal submitted to the GTB and the Appeal to Executive Authority submitted to the executive power (to which the GTB reports).

Should the executive power definitively confirm the Act of Determination appealed, or should it fail to issue a pronouncement within a term of 200 days after the date the appeal is presented, the taxpayer may bring an Action for Annulment at the Court of Administration Matters (CAM) within 60 days after confirmation (either tacit or expressed). The CAM will proceed to confirm or annul the act impugned by means of a verdict, which is definitive in nature.

It is worth mentioning that the CAM is an independent court written in the Constitution of Uruguay, which is competent to judge on the legality of all the acts of the administration.

The actions of filing, performing proceedings and resolving administrative resources submitted to the executive authority and the action for annulment are not subject to prior payment of taxes or related punitive charges.

Resources available to the tax authorities

As mentioned above, the administration has broad faculties for investigation and therefore can resort to various sources of information.

Law 18.083 introduces changes on the matter of 'secrecy of the administration's proceedings'. The tax code establishes that the tax administration and the staff members reporting thereto are obliged to keep all information resulting from their administrative or judicial proceedings confidential. The secrecy of the proceedings may be lifted only by means of a duly founded resolution of a judge. However, Law 18.083 has changed the secrecy rule for the area of TP, adding that the secrecy of the proceedings will not be applicable in connection with third-party information that might be necessary for determining the transfer prices when the administration must offer such information as evidence in cases brought to court or administrative jurisdiction.

In conclusion, the administration may use secret comparables as a means of proof for justifying the prices it has determined.

Legal cases
There have been practically no TP issues submitted to administrative or legal jurisdictions. This trend is expected to change as the regime becomes established.

To date, few verdicts of the CAM concern TP issues.

Verdict 8/982 issued in February 1982: This verdict defines 'economic group' and determines the tax effects regarding this figure. The Court refers to the concept of 'economic group' as the union of several legal entities dominated by one of those entities or by the same group of individuals, which under private law will be independent taxpayers. As such group has the purpose of transferring profits, or at least leads to this result in most cases, so as to cause the related loss of tax revenue to the GTB, tax law regards them as one single group for tax assessment purposes, assigning the total tax debt to any of its components or redistributing the profits to adjust them to what each of the group members would have obtained if they were independent entities. More recently, in Verdict 149/997 of 17 March 1997, the Court ratified the concept of 'economic group' in terms of the 1982 verdict.

Case: Philips Uruguay S.A. (Verdict issued on 19 February 2005): The Uruguayan subsidiary had entered into a general services' agreement with its shareholder in the Netherlands, comprising the following services: commercial advisory; accounting advisory; and audits regarding financial, fiscal and social matters for a consideration computed at 1.75% on the local sales revenue. The amounts paid for this concept had been deducted by the taxpayer in its business income tax return. The GTB questioned such tax deduction for years 1997 and 1998, alleging that the services lacked adequate documentation support and that they were neither indispensable nor reasonable for generating taxable income. The CAM, however, decided in favour of the taxpayer for various reasons. Regarding the reasonableness of the amount deducted by the taxpayer, the Court explicitly recognised the OECD Guidelines as valid criteria for fixing the transfer prices between related parties, in the context of regulations not providing any specific rules on this issue.

Case: Milagro S.A. (Verdict 688 issued in October 2006): In this case the GTB questioned the selling price of certain export transactions made by the taxpayer during 1996 and 1997, on the basis of the wholesaler's price rule – among other rules – established in the aforementioned Article 19 of Decree 840/988. Applying this rule, the GTB determined the income of the Uruguayan source on the basis of the wholesaler's price at destination (the Netherlands, in this case), overtaking the prices stated in the custom clearance documentation by prices indicated in the listings submitted by the Uruguayan Embassy in the Netherlands. Again, the CAM favoured the taxpayer in its verdict. While the arguments used as a basis for the decision are not clearly stated, the verdict is the first local jurisdictional precedent of the wholesaler's price rule.

Limitation of double taxation and competent authority proceedings
The Uruguayan taxation system continues adopting the source principle as the general criteria of taxability empowerment, and therefore does not recognise taxes paid abroad as creditable against taxes in Uruguay.

In order to avoid double taxation on income and on equity, Uruguay has signed agreements with 13 countries including, but not limited to: Germany, Hungary, Mexico, Spain, Portugal, Finland, Switzerland and Romania. There are other agreements in force (yet they only count with parliamentary approval) and others under negotiation. Moreover, there are treaties signed so as to exchange information with France, Argentina, Norway, Sweden and many others that are under negotiation.

Aligned with the OECD Guidelines, agreements adopt the concept of related parties and the arm's-length principle. These agreements foresee the possibility of establishing mutual agreement procedures between the competent authorities of each country in order to avoid taxation that is not within the scope of the agreement. Notwithstanding the open legal possibility of such agreements, there is no practical experience in this regard.

Advance pricing agreements

The APA instrument was introduced by Decree 392/2009 (Article 314 of Law 18.996 granted legal status to the APA provisions), which states that the GTB may execute APAs with taxpayers, which must be signed before performing the transactions under analysis and that may not exceed the term of the three following fiscal years from which the APA was signed. The term will be applicable to financial years closing after the year in which this regime comes into force.

The GTB has been empowered to establish the conditions and formalities required for subscribing such agreements.

The GTB is open to subscribe APAs.

Liaison with customs' authorities

Recent experience suggests that exchange of information between GTB and the custom authority does occur. Nevertheless, there is no prescribed approach for the use of certain information of one area in the other area (e.g. TP analysis for customs' purposes).

Joint investigations

Law 18.083 foresees the possibility of carrying out contemporary tax audits with foreign tax authorities.

Comparison with OECD Guidelines

Uruguay is not a member of the OECD. Nevertheless, the OECD Guidelines on TP constitute international points of reference for this subject. Their influence in Uruguay has been significant to the extent that effective from year 2005, the CAM has considered these Guidelines as valid directives for quantifying the transactions between related parties.

Law 18.083 does not explicitly mention the adoption of the OECD Guidelines, but the regulations in the law have conceptually followed some of them.

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Uzbekistan, Republic of

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Overview

Legislation on transfer pricing (TP) in Uzbekistan is currently in the early development stage. The Tax Code only establishes the right of the tax authorities to adjust transaction prices for tax purposes and provides the definition of related parties, but lacks other regulations necessary to apply the TP concept in practice (e.g. documentation requirements, price benchmarking guidelines, reporting obligations, etc.).

There have been discussions among regulators on the introduction of a separate TP law and, based on our knowledge, the first draft has been prepared by the tax authorities. However, we understand after initial discussions among the concerned state authorities that further work on elaboration of the TP regulations has been put aside for an indefinite period. It is unlikely the law will be enacted in the next 3–5 years.

Country	**Uzbekistan**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	No
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	N/A
When must TP documentation be prepared?	N/A
Must TP documentation be prepared in the official/local language?	N/A
Are related-party transactions required to be disclosed on the tax return?	N/A
Penalties	
Are there fines for not complying with TP documentation requirements?	N/A
Do penalties or fines or both apply to branches of foreign companies?	N/A
How are penalties calculated?	N/A

Uzbekistan, Republic of

Introduction

As of 1 January 2008, a new edition of the Tax Code was introduced, and there was no such provision until an amendment was introduced, as of 1 January 2010. As per the current Tax Code, transactions between related parties may be subject to adjustment by the tax authorities. If related parties in their operations use prices/rates different from the prices/rates that would have been used between unrelated entities, the tax authorities have the right to adjust those.

However, the effective tax legislation does not provide any further guidance on the application of these rules; therefore, there is currently no standard approach and plenty of disputes between taxpayers and the tax authorities on this matter.

Customs' authorities usually challenge taxpayers from a TP perspective regarding the customs' value of imported goods. The customs' authorities have their own prices' database and regardless of the actual value as per invoices/waybills, they assess the customs' payments thereof.

Legislation and guidance

Scope

Practice of application of TP in Uzbekistan may be conditionally divided into three areas: (i) taxation area, (ii) customs' area, and (iii) currency control area.

Related parties

Related parties are defined as:

- legal entities registered in Uzbekistan and their foreign shareholders (participants, members)
- foreign legal entities and their Uzbek shareholders (participants, members), and
- legal entities registered in Uzbekistan and legal entities of foreign states that have the same shareholders (participants, members).

Pricing methods

N/A

Other regulations

N/A

Control approach of the tax authorities

The tax and customs' authorities may carry out TP control during tax audits (there are no TP audits).

As noted above, the customs' authorities have their own prices' database and regardless of the actual value as per invoices/waybills, they assess the customs' payments thereof.

Risk transactions or industries

Please note that the Tax Code TP rules have been introduced relatively recently, and there is a short (if at all) history of their practical implementation.

Anticipated developments in law and practice
There have been discussions among regulators on the introduction of a separate TP law and, based on our knowledge, the first draft has been prepared by the tax authorities. However, we understand after initial discussions among the concerned state authorities that further work on the elaboration of the TP regulations has been put aside for an indefinite period. It is unlikely the law will be enacted in the next 3–5 years.

Liaison with customs' authorities
The Customs Code contains pricing rules that allow the customs' authorities to adjust the declared import or export value of cross-border transactions for customs' payments' (customs duty, excise and VAT) purposes.

These rules are well-described and used in practice. More specifically, they include instruction for how the adjusted price can be determined for customs' purposes. The Uzbek customs' authorities may use any of six methods available including the method of data on comparable goods and services.

Thin capitalisation
Current Uzbek legislation does not provide for any thin capitalisation rules, except for debt-to-equity ratios set out by the Central Bank of Uzbekistan (CBU) for commercial banks.

Penalties
Not applicable

Documentation
Not applicable

Transfer pricing controversy and dispute resolution
Legal cases
Tax Code TP rules have been introduced recently and there is a short (if at all) history of their practical implementation.

Burden of proof
Burden of proof is normally shifted to taxpayers.

Tax audit procedures
There are no separate TP audits; yet, TP may be reviewed during the normal tax audit by regulators.

Revised assessments and the appeals' procedure
Not applicable.

Joint investigations
Not applicable.

Advance pricing agreement (APA)
Not applicable.

Uzbekistan, Republic of

Comparison with OECD Guidelines

OECD interpretations are not applied in Uzbekistan because these are not considered as legislative acts as per Uzbek tax legislation.

105.

Venezuela

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Overview

Recent studies performed by the American Center of Tax Administration (ACTA) suggest that Latin American countries are classified into five different categories according to different aspects, such as: the amount of time in which transfer pricing (TP) rules were issued and implemented in the country, progress in terms of control/audit and any other aspect involving human resources. Venezuela was placed in Group II, which includes countries that have implemented TP rules and regulations, and that have achieved great progress within the area, covering most aspects that allow efficient control of the transfer prices. These countries also have departments exclusively devoted to perform audits and keep track of documentation requirements in order to guarantee that TP rules are being followed.

Country	**Venezuela**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	No
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Six (6) months after fiscal year end
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	No
How are penalties calculated?	25% to 200% of the tax omitted

Venezuela

Introduction

Venezuela experienced significant tax reform in 2001, especially in the area of TP. The 2001 Master Tax Code (MTC) establishes several TP principles including penalties relating to non-compliance with TP regulations, specific rules for TP audit procedures and the introduction of advance pricing agreements (APAs) to the Venezuelan tax system. Additionally, in December 2001, Venezuela enacted new TP regulations under the Venezuelan income tax law. The new Venezuelan TP rules adopt the arm's-length standard for related-party transactions, adhere to the Organisation for Economic Co-operation and Development(OECD) Guidelines, eliminate the safe harbour regime established during 1999, impose TP documentation and filing requirements, and contain APA provisions. With the addition of these new TP rules, Venezuela has taken an important and positive step towards the harmonisation of its tax system with internationally accepted standards. Moreover, in February 2007, Venezuela introduced thin capitalisation rules to its income tax law.

Legislation and guidance

The newer TP rules came into force on 28 December 2001. The provisions are applicable to all fiscal years initiated on or after 1 January 2002. The newer TP rules are based on the internationally accepted arm's-length standard, and therefore eliminate the previous safe harbour approach that specifically aimed at three types of transactions: importing, exporting and analysis of interest conducted by multinationals with their related parties in Venezuela.

Related parties are defined as parties that are directly or indirectly managed, controlled or owned by the same party or group, intermediary agents and any relationship between a Venezuelan taxpayer and entities located in low-tax jurisdictions (i.e. a country included in the list of tax havens). The arm's-length standard applies to all transactions including transfers of tangible and intangible property, services and financial arrangements.

A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances.

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

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

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

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

The TP methods specified in the Venezuelan Income Tax Law (ITL) are basically the same as those contained in the OECD Guidelines:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).

In terms of selection of the method, the Venezuelan ITL establishes that the taxpayer shall consider the CUP as the method of first choice. The tax authorities will evaluate whether the method applied by the taxpayer is the most appropriate one, given the characteristics of the transaction and the economic activity performed.

In late December 2010, through the Official Gazette N° 39.577, the Venezuelan Tax Administration introduced the procedure for the calculation of the arm's-length range. The procedure confirms the use of the interquartile range. Also, the procedure establishes that when the price, margin or amount of the transaction carried out between the taxpayer and foreign related parties is not within the arm's-length range, the taxpayer must adjust the results to the median.

Penalties

The MTC specifies three types of situations where penalties might arise:

- Various non-compliance issues relating to filing and documentation requirements; the most relevant penalty relates to the non-application of the TP methodology set up in the Venezuelan ITL.
- The illegitimate reduction of the taxable income because of action or omission of the taxpayer. The penalty ranges from 100% to 300% of the tax omitted.
- Fraud on the part of the taxpayer. This is subject to a jail sentence ranging from six months to seven years. The penalties established in the MTC are summarised in the table opposite.

Sanctions in regards to TP established in the new Venezuelan Organic Tax Code:

Type of Illicit Sanction	COT Article	Legal Assumption	Sanction		
			TU	Bs.	USD
Formal	103	(sub-paragraph 1)- Not filling returns or filling them with a delay of more than one (1) year	150 TU and 10 continuous days of closure of the office, premises or establishment	22.500	3.571
		(sub-paragraph 3) – Filling the return incompletely or with a delay lower than one (1) year	100	15.000	2.381
		(sub-paragraph 7) – Not filling the informative return of investments in low tax jurisdictions	2,000 and 10 continuous days of closure of the office, premises or establishment	300.000	47.619
		(sub-paragraph 7) – Filling the informative return of investments in low tax jurisdictions with delay	1,000	150.000	23.810
	104	(sub-paragraph 12) –Not to maintain or preserve the information and documentation that supports the Transfer Pricing calculations	1.000 TU and 10 continuous days of closure of the office, premises or establishment	150.000	23.810
	105	(sub-paragraph 1) – Not submitting information regarding the activities of the tax payer or of related third parties	100	15.000	2.381
		(sub-paragraph 3) – Submitting false or wrong information	100	15.000	2.381
		(sub-paragraph 5) – Reveal reserved information or using it improperly	1,000	150.000	23.810
	108	Failure of any other formal duty with no specific sanction.	100	15.000	2.381
Material	112	Illegitimate reduction of the taxable income due to action or omission.	100% to 300% of the omitted tax		
Sanctions with jail punishment	119	To incur in tax defraud by simulating, concealment, deception or any fraudulent maneuver, that results in lower payable tax.	6 Months to 7 Years		
	124	To reveal, directly or indirectly, divulge, make personal or improper use, of the confidential information provided by third parties that affect or may affect its competitive position.	3 Months to 3 Years		

Art. 108: The pecuniary sanctions of formal duties shall be increased by two hundred percent (200%) when these are done by individuals qualified by the Tax Administration as special.

Value of the tax units (TU): 150 *bolívares fuertes* (Bs.)

Documentation

Transactions and arrangements with foreign related parties must be reported to the tax authorities through an informative return, which must be filed within six months following the end of the fiscal year. This informative return must describe the types of inter-company transactions, the dates on which the transactions were executed, the amounts of each type of transaction, the TP method applied, and the result of each transaction (i.e. profit or loss). Further appendices require the taxpayer to disclose the profit and loss statement, segregated in two columns: related and unrelated parties.

Moreover, the taxpayer must develop and maintain TP documentation to support the analyses of its inter-company transactions. The Venezuelan rules also require an extensive list of formal duties on TP (background documentation), which includes, among others, the following items:

- An analysis of fixed assets and the commercial and financial risks related to the transaction including documentation to support the acquisition and use of assets.
- An organisational and functional overview of the taxpayer including information about the relevant departments and/or divisions, strategic associations and distribution channels.
- Information regarding the foreign related parties including type of business, main clients and shareholdings in group companies.
- An overview of the controlled transactions including activities carried out, dates, prices paid or charged and the applicable currency.
- Information on the main activities carried out by each of the relevant group companies as well as data on any changes affecting the group as a whole, such as capital increases or mergers.
- Financial statements for the taxpayer's fiscal year, prepared according to generally accepted accounting principles including balance sheet, income statement, stockholders equity statement and statement of cash flow.
- Agreements, conventions or treaties entered into between the taxpayer and foreign related parties including agreements related to distribution, sales, credits, guarantees, licences, know-how, use of trademarks, copyrights, industrial property, cost allocation, research and development, advertising, trusts, stock participation, investments in securities and other transfers of intangible assets.
- The method or methods used to set the transfer prices, indicating the criteria and objective elements considered to determine the proper application of the selected method.
- Information regarding the operations of the uncontrolled comparable companies.
- Specific information about whether the related parties abroad are, or were, subject to a TP audit, or if they are involved in procedures by the TP competent authority or a court. In that case a resolution shall be issued by the competent authorities and a copy of the findings must be filed.
- Information regarding the inventory controls.
- Information related to functional analysis and TP calculations.
- Any other information that may be deemed relevant or required by the Tax Administration.

Advance pricing agreements

The MTC enables the Tax Administration to approve or reject APAs and establishes the formal rules governing the APA application procedure. This procedure includes a list of the various documents that must be provided along with a taxpayer's application.

The taxpayer should present a proposal to the National Integrated Customs and Tax Administration Service (SENIAT as per its Spanish acronym) for the valuation of one or more transactions, providing evidence that such transactions comply with the arm's-length standard. The proposal should be prepared by the taxpayer and should be based on an accepted TP methodology. The SENIAT can determine the format of the documents to be provided by the taxpayer in the proposal. The APA proposal can be bilateral in cases involving the territories of tax treaty partners.

The APA process must be concluded by the end of the third year after the year of application. This period may be extended if the APA is being negotiated through a competent authority under a double tax treaty.

Either party may terminate the APA application process if commercial or operational changes occur in the assets, functions, or risks of the relevant parties.

The SENIAT may terminate the APA if it concludes that fraud was committed or false information was provided in the APA proposal. The SENIAT may also terminate an APA in the event of non-compliance with the agreed terms and conditions (T&C). If the SENIAT rejects an APA application, the taxpayer cannot seek any of the administrative solutions included in the MTC and other laws. The only course of action available is to initiate a new APA application.

Thin capitalisation

On 16 February 2007, the partial amendment of the Venezuelan ITL included Article 118 to introduce thin capitalisation rules. These rules state that the interest paid directly or indirectly to related parties will be tax-deductible, only if the amount of the debts with the related parties (directly or indirectly received) plus the debts with independent parties does not exceed the amount of the taxpayer's equity. This debt-equity ratio of 1:1 is the strictest in Latin America, where most of the countries require a 3:1 ratio.

Moreover, to determine if a debt was received at arm's-length conditions, the tax authorities will consider (i) the level of debt of the taxpayer, (ii) the possibility that the taxpayer could have obtained the loan from an independent party without the intervention of a related party, (iii) the amount of debt that the taxpayer could have obtained from an independent party without the intervention of a related party, (iv) the interest rate that the taxpayer would have obtained from an independent party without the intervention of a related party, and (v) the T&C of the debt that the taxpayer would have obtained from an independent party without the intervention of a related party.

Transfer pricing controversy and dispute resolution

Some TP cases have been brought to the courts and one of them was resolved with a ruling in favour of the Tax Administration. Transfer pricing audits began in February 2005 and have been expanding since then, both in the number of audits performed and in the scope of their requirements. Initially, the SENIAT visited several taxpayers requiring the TP support documentation detailed above, and the Tax Administration usually gave the taxpayers a three- to five-day period to submit the required information.

In July 2006, the SENIAT conducted the first extensive TP audit to the local subsidiary of a global Japanese automotive company. The SENIAT explained that the audit procedure was applied to control the transactions among the Venezuelan taxpayer and its foreign related parties, so as to ensure that such transactions were conducted at arm's length. SENIAT, acting under the guidelines of the 'zero tax evasion plan', ensured that tax collection in this matter was not reduced as a result of illicit acts.

By the end of 2006, SENIAT's tax audit manager announced the reinforcement of the 'zero tax evasion plan' regarding TP audits, changing its previous focus on formal documentation compliance (availability of said documentation) thorough the audit of the arm's-length nature of the inter-company transactions that were detected by SENIAT's computerised system. Moreover, it was stated that SENIAT's TP unit would be expanded and certain tax inspectors would be relocated from the economic studies section to the tax audits management.

Consequently, a few weeks after that announcement, the SENIAT notified the local affiliate of a foreign global oil and gas company that a TP adjustment of USD 17.7 million was assessed by the TP unit using its databases, supporting documentation and analyses. This was the first TP adjustment in Venezuela, and it is related to certain financial transactions of the Venezuelan taxpayer involved with its foreign-related parties. In addition, SENIAT's head officer had warned that the TP audits were going to be reinforced and would focus on the oil and gas industry.

In April 2007, a local filial company of the foreign oil and gas company accepted part of the TP adjustment proposed by the SENIAT and paid USD 13.7 million, concluding the first TP case in Venezuela.

During 2007 and 2008, the audit activity in the oil and gas business, and related sectors in Venezuela continued as part of the migration (conversion) from operating agreements and strategic associations of the Orinoco Oil Belt to mixed companies. The main issue in these audits was the transactions carried out with related parties abroad.

Since the beginning of 2009, SENIAT has carried out several TP audits of taxpayers from several industrial sectors and concluded some audits with adjustments to taxpayers including automotive, pharmaceuticals and consumer products companies. Transfer pricing adjustments exceeded USD 25 million in 2009, in which the main issues rejected were tax deductions and the calculation of the arm's-length ranges. Other items reviewed by the tax authority within audits included financial segmented information, supports related to services, shutdown costs, restructuring expenses, idle capacity and selection criteria of comparable companies in the application of the TNMM.

In 2010, the Tax Administration continued with the audit process and made TP adjustments to companies in the food and automotive sectors.

In 2011, an important telecommunications' company paid USD 45,052 to the Tax Administration after a TP audit process, due to irregularities in the adjustment to the interest rates paid on loans carried out with its headquarters domiciled abroad in 2004.

Additionally, an important automotive company paid USD 1,404,790 to the Tax Administration, due to omitted taxes that generated a penalty of 10% plus default interests.

In the last two years and especially in 2012, the Tax Administration has focused on the verification of formal duties; specifically it has audited those taxpayers, who according to their databases, may be subject to the regime, but have not reported or documented the transactions under such regime.

Burden of proof
The burden of proof lies with the taxpayer. However, a challenge by the SENIAT would require adequate supporting evidence if such challenge is to be accepted by the tax courts.

Any transaction between a Venezuelan taxpayer and an entity located in a low-tax jurisdiction will automatically be presumed to be a transaction with a related party and will also be considered not to take place at arm's length. In such cases, the taxpayer has the burden of proof, and it will be necessary to demonstrate either of the following:

- The counterparty to the transaction was an independent third party.
- If the counterparty to the transaction is a related party, the transaction was carried out at arm's length.

Tax audit procedures
The MTC establishes specific rules for TP audits:

- When a tax objection is made by the SENIAT during a TP audit, the taxpayer may either accept the objection and settle with the Tax Administration, or start summary proceedings to defend its position. The taxpayer has more time to submit the defence documents and collect proof than in a regular summary proceeding: five months as opposed to 25 days.
- Within the first 15 days of the summary proceeding, the taxpayer may designate a maximum of two representatives to evaluate the information gathered by SENIAT regarding related-party transactions. Such representatives may be replaced once.
- The period for furnishing proof is the same granted to a regular proceeding with SENIAT: a maximum of 30 days. SENIAT has a two-year period to make a decision about the TP audit, once the period of negotiations and information exchange is over.

Comparison with OECD Guidelines
Although Venezuela is not a member of the OECD, Venezuelan tax authorities have adopted the arm's-length standard and the use of the methodologies endorsed by the OECD Guidelines.

106.

Vietnam

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Overview

Following international trends of increased transparency and compliance, there have been significant developments in Vietnam's transfer pricing (TP) regulatory environment:

- Since the introduction of a formal advance pricing arrangement (APA) programme in February 2014, the APA programme is in full force. There are three APAs currently lodged, and an additional two cases are expected to be filed by the end of the year.
- The revised TP declaration forms to be submitted along with the tax return filing (effective for tax years commencing on, or after, 1 January 2014) places the onus on the taxpayer to prove that each transaction is conducted at arm's length. Specifically, taxpayers are now required to make a positive declaration that their transfer prices adhered to the arm's-length principle, or, in the alternative, make a voluntary adjustment. As the majority of taxpayers have already submitted the revised TP declaration forms, the impact of these forms, including next steps taken by the tax officials, if any, is expected to surface by year end.
- Audit activity continues to increase in both the number of cases and scale of TP adjustments across various industry sectors. Likewise, taxpayers seeking appeals, including case reviews, mediation, etc., through the General Department of Taxation (GDT) in Hanoi are on the rise. Recently, there are even cases of taxpayers seeking relief through mutual agreement procedures (MAP).

Country	**Vietnam**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Not formally, but adopts broad principles
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes

Vietnam

Country	Vietnam
TP documentation	
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	Transfer pricing documentation is required to be contemporaneous and needs to be provided to the tax authorities within 30 days of a request.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the additional tax assessed

Introduction

Vietnam has been carrying out economic reforms since 1986 under the '*Doi Moi*' (Renovation) policy, which focuses on market-oriented economic management. This reform has included: (i) restructuring to build a multi-sector economy; (ii) financial, monetary and administrative reform; and (iii) the development of external economic relations.

One of the most important aspects of economic reform in Vietnam has been the encouragement of domestic and foreign private investment with the introduction of the Law on Foreign Investment in 1987. The first tax law was introduced in the early 1990s. Since then the tax system has been subject to various changes and amendments. The first proper TP regulations were introduced at the end of 2005 and came into force in 2006.

On 20 October 1997, the MOF issued Circular 74-TC/TCT, which was the earliest legal document to define related parties from a Vietnamese context. However, the applicability of this circular was limited to foreign-invested enterprises. Circular 89/1999/TT-BTC, which was issued on 16 July 1999 also provided guidance on the definition of related parties. However, both these circulars did not specifically stipulate the TP methods to be used or the documentation requirements.

The MOF issued Circular 13/2001/TT-BTC (Circular 13) on 8 March 2001 to provide guidelines on the implementation of the Law on Corporate Income Tax, applicable to foreign-invested enterprises. This circular specified three traditional TP methods applicable to the determination of the arm's-length nature of related-party transactions as follows:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost-plus (CP) method.

However, Circular 13 did not provide detailed guidelines on the application of the statutory methods or guidance on documentation requirements.

The MOF issued Circular 117/2005/TT-BTC (Circular 117) on 19 December 2005 to provide guidelines on related-party transactions and disclosure of documents and information thereof. Circular 117 was applicable to both cross-border and domestic related-party transactions. Besides the requirement for companies to comply with the arm's-length standard, it also required companies to submit an annual TP declaration form and maintain contemporaneous transfer pricing documentation (TPD) as from 2006 onwards. Non-compliance will be subject to a fine of up to 5 million Vietnamese dong (VND).

On 22 April 2010, the MOF issued Circular 66/2010/TT-BTC (Circular 66), replacing Circular 117. Circular 66 came into force on 6 June 2010.

Similar to Circular 117, Circular 66 retained the main compliance requirements (i.e. requiring corporate taxpayers to comply with the arm's-length principle, submission of annual TP declaration form and maintaining contemporaneous TPD). However, Circular 66 also introduced several changes that tightened the TP requirements. For example, the circular clarifies that the median value of an interquartile range will be used to benchmark against companies' margins for the purposes of TP adjustments, and greater information is required to be disclosed in the annual TP declaration form (new categories of related-party transactions, nature of related-party relationships, related-party addresses and tax codes are now required).

On 21 May 2012, the MOF released guidance on action plans concerning TP for the period 2012 to 2015 via issuance of Decision 1250/QD – BTC. The General Department of Taxation (GDT) will primarily be responsible for implementation of the TP action plan.

Such action plans are not intended to create an aggressive TP/tax regime for inbound investments, but focuses on TP audits and 'abusive' TP practices. Under the action plan, the focus is on five key elements:

- Transfer pricing audits in 20% of annual tax audits/inspections at both the central and provincial levels, with a TP audit manual to be developed:
  - Under the said decision, at least 20% of annual tax audits/inspections at both central and provincial levels will be carried out for TP purposes. In conjunction with such efforts, a formal TP audit manual will also be developed.
  - In addition, audits will likely be carried out on companies with significant related parties or those that carry out transactions deemed high TP risks.
- Enhance TP regulations by introducing specific guidance on managing abusive TP practices:
  - GDT will introduce specific guidance on management of abusive TP practices. As such, the requirements of taxpayers' statutory TP disclosures will also be increased.
- Enhance capacity of TP auditors, by building on practical audit experience and international practices:
  - To set up a specialised TP task force team at the GDT. Such efforts will also be replicated at provincial level.

- Creation of a database of companies operating in 'high' TP risk sectors and of prices for certain products:
  - A database comprising both secret comparables (to be collected internally within the revenue authorities and from different ministries) and external sources (including independent databases and foreign tax authorities via an exchange of information) will be set up by the GDT.
- Coordination among government ministries and international cooperation with foreign tax authorities:
  - Enhance exchange of information and technical capabilities for implementation of an agreement for the avoidance of double taxation and prevention of fiscal evasion among government ministries and foreign tax authorities for the purpose of TP management.

As part of the above action plan, Circular 201/2013/TT-BTC formally introduced the APA regulations from 5 February 2014.

Legislation and guidance

Circular 66/2010/TT-TBC (Circular 66) is the current source of TP regulations in Vietnam.

Persons covered

The provisions of Circular 66 are applicable to organisations that are subject to corporate income tax (CIT) in Vietnam and are carrying out business partly or wholly in Vietnam with related parties.

Transactions covered

Any transaction that is carried out between related parties may come under the scope of Circular 66. However, related-party transactions involving products whose price is placed under state control are excluded from the scope of Vietnam's TP rules.

Definition of related parties

The definition of related parties in Circular 66 is broad, with a low capital participation threshold of 20% (either directly or indirectly).

The definition of a related party also includes significant business relationships (or economic dependencies) between parties unconnected from an ownership perspective. Where a Vietnamese company's sales or purchases from an entity exceed 50% of the total sales or the sum total of cost of raw materials, materials and supplies, or input products, these transactions are regarded as related-party transactions.

The related-party definition also extends to intangible assets/intellectual property (IP) and company financing. Parties are considered as being related when:

- an enterprise uses intangible assets/IP provided by another party that accounts for more than 50% of its production costs, and
- an enterprise guarantees the other enterprise's loans, or makes a loan to the other enterprise where the loans account for at least 20% of the charter capital of the borrower and more than 50% of the total liabilities of the borrower.

Additionally, under Vietnamese TP regulations, parties with any of the following management or business relationships would also be considered related:

- One party is directly or indirectly engaged in the management, control, contribution of capital to, or investment in, the other party.
- The parties are directly or indirectly subject to the management, control or capital holding by another party.
- Contribution or investment in all forms by another party.
- The parties directly or indirectly participate in the management, control, capital contribution or investment in another party.
- Two parties have entered into a business cooperation agreement on a contractual basis.

The extension of the related-party definition under Circular 66 has rendered many parties, which would otherwise be considered as independent, to be classified as related parties for Vietnamese TP purposes.

Broadly based on the OECD Guidelines, Circular 66 contains guidelines on comparability analysis, TP methods, selection and application of the most appropriate method, and documentation requirements.

Comparability analysis

Part B, Article 4 of Circular 66 has detailed guidance with respect to the comparability analysis. When comparing a related-party transaction against a comparable independent transaction, a comparability analysis must be carried out and adjustments made (if necessary) to the following four main influential factors:

- Product property/characteristics.
- Operational functions.
- Contractual terms.
- Economic conditions of transactions.

The priority given to each of the above factors in the comparability analysis varies, depending on the most appropriate TP method selected. Under the comparability analysis, the factors that are considered to be the main influential factors need to be analysed in detail, while the auxiliary factors should be analysed only at a high level.

Transfer pricing methods

Part B, Article 5 of Circular 66 sets out five TP methods to be used for determining the arm's-length price. These methods are similar to the TP methods specified in the OECD Guidelines, which are as follows:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus (CP) method.
- Comparable profits method (CPM).
- Profit split method (PSM).

The Vietnamese version of the comparable profits method is equivalent to the OECD's transactional net margin method (TNMM). Furthermore, the Vietnamese TP regulations recommend that preference be given to the comparison of the transfer price or profit margin of transactions with related parties against those with independent parties of the same taxpayer (internal method comparables).

The taxpayer is required to use data of at least three continuous fiscal years for benchmarking purposes where TP methods involve the use of profit margins.

Further, at year-end, taxpayers are required to disclose related-party transactions via a TP declaration form (form 03-7/TNDN), which is submitted together with the annual CIT return, which is filed within 90 days of the end of a taxpayer's financial year-end.

Penalties

No specific penalty is provided for in the TP regulations under Circular 66. However, tax authorities have the right to assess and make appropriate adjustment, as the case may be, to the transfer price, taxable income or tax amount payable where they have evidence that the taxpayer has: (i) failed to comply with the compliance requirements of Circular 66; and (ii) committed tax evasion or fraud by manipulating transfer prices with related parties. In this case, the adjustment to be made is established by transfer prices or profit margins established by independent parties. The value of transfer prices or profit margins used for tax authorities' assessment is not to be lower than the median of the arm's-length range.

Further, in accordance with the Law on Tax Administration and its implementing guidelines, non-compliance subjects the taxpayer to the following categories of penalty:

- Non-compliance with tax filing procedures and/or submission of incomplete returns could be subject to a penalty of up to VND 5 million (approximately USD 250).
- Late payment of tax is subject to interest of 0.05% per day of the outstanding tax amount.
- Underreporting of tax liabilities could be subject to a penalty of up to 20% of the underpaid amount, regardless of whether the taxpayer keeps all related supporting documents and presents them to the tax authorities upon request.
- Tax evasion could be subject to a penalty of up to three times the outstanding tax liability.

Documentation

Vietnamese taxpayers are required to record and maintain contemporaneous documentation, and to submit that documentation to the tax authorities within 30 working days upon a request, in Vietnamese.

Transfer pricing documentation under Circular 66 should include:

- General information on the business establishment and related parties.
- The business establishment's transactions.
- The methods of calculation of arm's-length prices.
- An assessment of comparable data used to apply a methodology.

Transfer pricing controversy and dispute resolution

Legal cases

No legal cases concerning TP have been decided by the courts to date. Any cases involving disputes on TP issues have so far been settled out of court and the details have not been published. In order to set examples, it is anticipated that the tax authorities could bring cases involving abuses of TP to the courts in the future.

Burden of proof

Vietnam is a self-assessment regime, and the taxpayer bears the burden of proof. In accordance with prevailing regulations in relation to TP and tax administration, the taxpayer is obliged to satisfy the burden of proof by:

- disclosing related-party transactions on a TP declaration form (form 03-7/TNDN) accompanied by the annual CIT return, and
- documenting and reporting information/evidence regarding related-party transactions and the relevant related parties in a TPD, demonstrating that the related-party transactions are consistent with the arm's-length principle set out in the TP regulations.

The record-keeping and documentation requirements under Circular 66 are onerous. The taxpayer is required to submit TPD within 30 working days from the date of the request from the tax authorities. A one-time extension of another 30 days may be accepted if it is considered reasonable.

Tax audit procedures

In accordance with prevailing tax administrative regulations under Circular No. 156/2013/TT-BTC issued by the MOF on 06 November 2013, a tax audit can be conducted at the tax office or at the taxpayer's premises. Based on the result of the tax audit at the tax office, the tax authorities may decide to conduct a tax audit at the taxpayer's premises.

Tax audit procedure at the tax office (desk review)

Tax officials examine the tax declaration dossier filed by the taxpayer to verify whether the tax amount assessed and declared by the taxpayer is appropriate, based on a comparison with relevant data available to the tax authorities. In the case of an abnormality in the declared tax amount or missing information which could point to tax evasion or the under-declaration of taxes, the relevant taxpayer is required to provide an explanation and additional information/evidence within ten days from the date of receipt of the authorities' first request. If further information is still required by the tax authorities, the taxpayer has ten days from the date of receipt of the second request of the tax authorities to provide information to justify his/her tax liability assessed and declared in the tax return.

After the second request, if the taxpayer fails to justify the appropriateness of his/her tax liability declared either with or without additional information/explanation, the tax authorities are entitled to:

- assess the tax liability of the taxpayer in question based on the information/data available to the tax authorities, and
- issue a decision to carry out a tax audit at that taxpayer's premises if the information/data available to the tax authorities is not considered adequate to issue an assessment of the tax liability as above.

Tax audit procedure at taxpayer's premises
The execution of the tax audit must be carried out within ten working days from the date of the issuance of the decision to perform a tax audit at the taxpayer's premises. However, the decision on such a tax audit shall be cancelled if, before the tax audit starts, the taxpayer can justify the appropriateness of the declared tax liability or accepts and pays the tax amount assessed by the tax authorities.

The duration of a tax audit at a taxpayer's premises should not exceed five working days. A one-time extension of another five days is permissible if necessary.

At the end of a tax audit, a report must be issued describing the findings and conclusions of the tax auditor team. The taxpayer has the right to make an appeal against the conclusion of the tax audit team.

If the result of the tax audit raises concerns on potential tax evasion or fraud, the case is reported to the head of the relevant tax authority for further investigation and/or inspection.

Tax inspection
In practice, tax inspections are normally conducted on the basis of an annual plan developed by the tax authorities, except where there are signs of tax evasion and/or fraud, for the purpose of resolving appeals, or at the request of the heads of tax administration bodies at all levels or by the Minister of Finance. A taxpayer can be subject to tax inspection not more than once per year.

Where the tax law has been infringed, a tax inspection can be conducted only if the tax authorities have evidence of tax underpayment, tax evasion, or tax fraud.

A decision on tax inspection has to be communicated to the taxpayer within 15 days from the date of issuance. The duration of a tax inspection cannot exceed 30 working days (45 working days for a complicated case). A one-time extension of another maximum 45 working days may be permitted under certain conditions.

At the end of a tax inspection, a report must be issued within 15 working days to document the findings including the opinion of each inspection team member. The taxpayer has the right to make a formal objection to the inspection team's observations.

Within 15 working days from the date of receipt of the inspection report, the head of the relevant tax authority must issue a letter specifying the result of the tax inspection. If the taxpayer still disagrees with the conclusion of the tax authorities, he/she can file an appeal following the procedure stipulated in the law on appeals.

As there is no audit procedure set out specifically for TP, a TP audit could be implemented separately or in conjunction with a tax audit adopting the said procedures. The tax authorities have increased their focus on TP by undertaking the following initiatives:

- Companies with related-party transactions and loss-making companies are likely to be targeted for audits.
- Increasing number of TP queries raised during normal tax audits.
- Compilation of a target list for TP audits, comprising both multinational enterprises and local companies that generate consecutive losses.

- Carrying out desk reviews and focusing on factual analysis.
- Requesting TP declaration forms and TPD from taxpayers.

Revised assessments and the appeals' procedure

In the event that the taxpayer considers the administrative action taken by the tax official or the decision issued by the tax authorities (e.g. in relation to tax liability, tax reimbursement, tax exemption/reduction including the conclusion of the tax audit) is a breach of the taxpayer's rights, the taxpayer is entitled to file an appeal against this decision.

To resolve appeals the authorities follow the administrative hierarchical order from the local office to the MOF. The head of each hierarchical body is responsible for resolving the appeal against the administrative decision issued by his/her office and/or action taken by his/her staff or by him/her.

The appeals' procedure is the same as that of the general laws on appeals. In practice, where the taxpayer disagrees with the conclusion of the tax inspection of the competent authorities, including the MOF, the taxpayer can file an appeal in the administrative court against the conclusion in question. However, there is no tax court in Vietnam.

Advance pricing arrangements (APAs)

The National Assembly of Vietnam introduced the mechanism for an pricing APA programme in Vietnam as part of amendments made to the Law on Tax Administration (Law 21/2012/QH13), which became effective from 1 July 2013.

The MOF released Circular 201/2013/TT-BTC (Circular 201) on 20 December 2013, which provided formal guidance on the APA programme, including the APA framework, governance, process, roles, responsibilities and mutual expectations for taxpayers and the Vietnamese authorities in applying for, negotiating, and executing, APAs. Circular 201 became effective from 5 February 2014.

The APA application process

All Vietnamese taxpayers with related-party transactions (including domestic transactions) can apply for an APA to cover either one or more of their transactions with related parties. Like Vietnam's TP rules, all submissions must be made in Vietnamese (excluding any lengthy appendices).

The APA process contains four substantive phases, comprising:

- **Consultation (or pre-filing) phase:** Taxpayers submit a pre-filing consultation request to the GDT, along with substantial information with respect to the taxpayer, its related-party transactions (and relevant related parties), TP policies and financial outcomes, in order for the GDT to make an informed decision as to whether to accept the APA into the programme.
- **Formal APA application (or lodgement) phase:** Following acceptance into the APA programme, taxpayers lodge a formal APA application, which sets out their position with respect to the characterisation of the taxpayer and its related parties and the selection and application of a TP methodology including the outcomes of the methodology over the APA period. The APA application is broadly consistent with the process that taxpayers would follow when preparing contemporaneous TPD, albeit that a greater level of detail and analysis is required.

- **Evaluation and assessment phase:** Post submission of the APA application, the GDT undertakes its evaluation and assessment of the APA application, which involves fieldwork and analysis by tax officials. During this phase, the GDT will request any additional information required, or clarifications of material contained in the application. Based on our experiences with multinationals piloting the APA programme, we expect these requests to be significant, at least in the initial applications.
- **Discussion and negotiation phase:** After the GDT has completed its analysis, the GDT and the taxpayer (or in the case of a bilateral or multilateral, other tax authorities) will commence discussions and negotiations to determine a mutually acceptable outcome.

Once agreement has been reached, the APA is executed. In the spirit of the collaborative nature of the programme, if at any time the APA process is withdrawn from, or agreement cannot be reached, the tax authorities cannot use any information provided as evidence in an investigation or audit.

The overall APA process, as outlined in Circular 201, would take upwards of nine months from the date of the pre-filing consultation request (which is a significant reduction from the timelines specified in the initial draft). As extensions are available for both parties, the actual time taken may vary. Our experience to date with those taxpayers piloting the APA programme indicates a lengthy, involved process as experience is gained in assessing, negotiating and executing APAs.

Over the term of the APA, taxpayers are required to lodge a brief annual APA report (due at the same time as their corporate income tax return), which evidences their compliance with the agreed APA terms and conditions. This significantly reduces the ongoing compliance costs of the APA over its term.

In the event of a breach of a critical assumption, the taxpayer needs to inform the GDT within 30 days of the breach – and a meeting will be held to determine an appropriate course of action – to continue, modify, suspend or cancel the APA.

Throughout the APA, taxpayers self-assess their transfer prices to arrive at the agreed upon prices or outcomes and can make compensating adjustments to their taxable income to do so.

Limitation of double taxation and competent authority proceedings

Vietnam has more than 60 double taxation agreements (DTAs) concluded with other countries and territorial areas. Most DTAs contain an 'Associated Enterprise' Article modelled on the OECD convention. However, a large number of DTAs exclude the provision that permits the respective tax authorities to adjust the profit of an entity where the transaction is judged not to be at arm's length (paragraph 2 of Article 9 of the OECD convention model).

A number of DTAs include the previously mentioned provision, but exclude the accompanying provisions in the article requiring one contracting country to reduce the amount of tax charged to offset the increased tax liability imposed by the other contracting country as a result of the arm's-length adjustment. Currently, there is no set procedure laid out for the initiation of a MAP in event of double taxation as a result of TP adjustment or otherwise. Despite the lack of guidance, it is still possible to lodge a MAP in Vietnam through close dialogue with the GDT, based on PwC's experience in assisting certain taxpayers on such matters.

Comparison with the OECD Guidelines

Vietnam is not an OECD member country; however, Circular 66 (Vietnam's TP regulations) is modelled on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. Circular 66 adopts the arm's-length principle and the TP methods set out in the OECD Guidelines.

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Zambia

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Overview

The Zambian Government through the Zambia Revenue Authority (ZRA) is increasingly putting in place legislation aimed at maximising revenue collection from international transactions. Transfer pricing (TP) is one area that this action is focused on. This Government action has in in part been fuelled by the growing debate around base erosion and profit shifting (BEPS) and how this impacts developing countries such as Zambia.

Zambia TP rules generally apply equally to domestic and cross-border transactions between related parties. The onus is on the related parties to prove that the transactions between themselves are at arm's length and therefore satisfy TP regulations. This gives rise to the need for organisations to prepare appropriate documentation to demonstrate this. Failure to do so may give rise to penalties and interest as set out in the Income Tax Act of 1966 as amended.

The TP legislation has been in existence since 1999 with some subsequent amendments. Currently, the ZRA are implementing their capacity building and enforcement enhancing strategies with respect to TP. The ZRA are also working to introduce detailed regulations with respect to TP documentation. It is anticipated that the TP policy and documentation for Zambian taxpayers will need to be localised to Zambia TP provisions and will have to be in line with the guidance provided in the Organisation for Economic Co-operation and Development (OECD) TP Guidelines.

There have not been any notable court cases on TP in Zambia yet.

Country	**Zambia**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	Yes
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes

Zambia

Country	Zambia
TP documentation	
Can TP documentation provide penalty protection?	Yes
Can TP documentation provide penalty protection?	Yes
When must TP documentation be prepared?	When a request is made by the ZRA.
Must TP documentation be prepared in the official/local language?	Yes
Are related-party transactions required to be disclosed on the tax return?	Yes
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of both the adjustment to taxable income and the adjusted tax due.

Introduction

Transfer pricing legislation was first introduced in Zambia in 1999 and was subsequently amended in 2001, 2002 and 2013. The scope of the TP provisions for Zambia is contained in Sections 97A to 97D of the Zambia Income Tax Act 1966 (Zambia Income Tax Act), read together with the Transfer Pricing Regulations 2000 (the Regulations), as well as the final draft Practice Note (Zambia draft Practice Note) issued by the Zambia Revenue Authorities (ZRA). The ZRA are significantly scaling up their TP capacity and we expect more rigorous TP audits going forward.

Legislation and guidance

Section 97A of the Zambia Income Tax Act introduces the arm's-length principle. The Income Tax (Transfer Pricing) Regulations 2000 (TP regulations) also provide further definitions regarding the extent of application of the TP provisions contained in the Income Tax Act. In March 2005, a draft Practice Note was issued by the ZRA, which provides detail on how the ZRA will apply the TP rules. Zambia does not tax on a worldwide basis and, the legislation aims to counter tax losses brought about by non-arm's-length pricing. Furthermore, the TP legislation applies only in situations where the effect of the associated party pricing is to understate Zambian profit or overstate Zambian losses.

Zambia's TP policy applies not only to cross-border transactions but also to transactions between Zambian taxpayer residents who are wholly and solely within the Zambian tax jurisdiction (i.e. domestic transactions). This is to ensure losses are not effectively shifted between taxpayers or between sources by applying non-arm's-length pricing. In addition, the TP legislation applies to companies as well as partnerships and individuals.

Section 97A (2) of the Zambia Income Tax Act states that the provisions relating to TP apply:

"where a tax payer engages in one or more commercial or financial transactions with an associated person and the actual conditions having being imposed instead of the arm's-length conditions there is, except for this section, a reduction in the amount of income taken into account in computing the income of one of the associated persons referred to in subsection (1), in this section referred to as the first taxpayer, chargeable to tax for a charge year, in this section referred to as the income year."

The phrase 'actual conditions' is defined in Section 97A(1) of the Zambia Income Tax Act as "conditions made or imposed between any two associated persons in their commercial or financial relations".

'Associated persons' is defined as in Section 97 (c) of the Zambia Income Tax Act where one person associates with another if one of the following applies:

- One participates directly or indirectly in the management, control or capital of the other.
- The same persons participate directly or indirectly in the management, control or capital of both of them.

Amendments to the transfer pricing provisions of the Income Tax Act

The 2008 amendments to the TP provisions of the Zambia Income Tax Act introduced specific provisions applicable to the mining sector.

The new subsections 97A (13) to (17) deal with transactions for the sale of base metals and precious metals or substance containing base metals or precious metals between associated parties. The subsections state that the price applicable should be the reference price that is aligned with prices on the London Metal Exchange or any other metal exchanges approved by the Commissioner General or to the Metal Bulletin.

New provisions under the Mines and Minerals Development Act

The provisions of Section 97A of the Zambia Income Tax Act have also been cross-referenced to the new Mines and Minerals Development Act in determining arm's-length gross value and the norm value of minerals for the purposes of determining the mineral royalty payable to the government by mining companies.

Amendments to the Property Transfer Act

The Property Transfer Tax Act was amended and makes a direct reference to Section 97A of the Zambia Income Tax Act for the purposes of determining the realised value for shares transferred.

Final draft TP Practice Note

The Zambia draft Practice Note (the draft PN) states that in relation to a body corporate, one participates directly in the management, control or capital of the body corporate if they have 'control' over the body corporate. 'Control' means the power of a person to secure that the affairs of the body corporate are conducted in accordance with the wishes of that person. Such power would be derived from shareholding or other powers conferred by the constitutional documents of the body corporate.

The draft PN states that a person indirectly participates in a second-person corporate if the first person would be a direct participant (hereinafter referred to as the potential participant) due to:

- Rights and powers that the potential participant, at a future date, is entitled to acquire or will become entitled to acquire.
- Rights and powers that are, or may be required, to be exercised on behalf of, under the direction of, or for the benefit of the potential participant.
- Where a loan has been made by one person to another, not confined to rights and powers conferred in relation to the property of the borrower by the terms of any security relating to the loan.
- Rights and powers of any person with whom the potential participant is connected.
- Rights and powers that would be attributed to another person with whom the potential participant is connected if that person were himself the potential participant.

The draft PN further includes in its definition of 'indirect participation', joint ventures that are able to use non-arm's-length prices to shift profits overseas for their mutual benefit. The rules apply only to transactions between at least one of the joint-venture parties (referred to as the major participant) and the joint venture itself and not between two joint ventures unless they are under common control.

Section 97C (3) of the Zambia Income Tax Act states that conditions are taken to be imposed by an arrangement or series of arrangements, or agreement or series of agreements. The definition is wide and includes:

- transactions, understandings and mutual practices, and
- an arrangement or agreement whether it is intended to be legally enforceable.

Further, the arrangement or agreement or series of arrangements or agreements may not have to take place between two related parties (e.g. thinly capitalised taxpayers paying interest to third parties under finance arrangements guaranteed by associates). Section 97AA of the Zambia Income Tax Act is more specifically aimed at thin capitalisation and is discussed in more detail below.

Financial arrangements extend to interest, discounts and other payments for the use of money, whether these are receivable or payable by the person under review.

Thin capitalisation

Thin capitalisation is dealt with primarily by Section 97A and 97AA of the Zambia Income Tax Act. Guidance on thin capitalisation and the charging of excessive interest is provided in the draft PN.

Thin capitalisation commonly arises where a company is funded by another company in the same group or by a third party, such as a bank, but with guarantees or other forms of comfort provided to the lender by another group company or companies (typically the foreign parent company).

In the mining sector, legislation provides for a maximum debt equity ratio of 3:1. However, in other sectors, there is no fixed limit and general arm's-length principles are applied as described below.

The ZRA seeks to establish the terms and conditions that a third-party lender would have required if it had been asked to lend funds to the borrower. This involves the consideration of, for example: the type of business; the purpose of the loan; the debt-to-equity ratio of the borrower; the income cover, profits cover or cash-flow cover; and any additional security available. This list is not exhaustive; the governing factor is what would have been considered arm's length.

If the borrowing under consideration would not have been made at arm's length on the terms that were actually applied, the ZRA may seek to adjust those terms to those that would have been applied at arm's length. This may involve the adjustment of the rate of interest payable, the amount of the loan and any other terms of the loan that would not be found in an arm's-length borrowing. Furthermore, the ZRA may limit the interest deduction on interest actually incurred to that which a Zambian borrower would have incurred at arm's length.

Penalties

If the ZRA makes a legitimate and reasonable request in relation to a tax return that has been submitted, or should have been submitted, a taxpayer may be exposed to the risk of penalties if the primary records, tax adjustment records, or records of transactions with associated entities are not made available. In addition, the taxpayer may be exposed to further risk if no evidence is made available within a reasonable time to demonstrate appropriate arm's-length results of transactions to which TP rules apply or if the evidence made available by the taxpayer is not a reasonable attempt to demonstrate an arm's-length result.

When considering whether a reasonable attempt has been made to demonstrate an arm's-length result, the ZRA observes the same principles of risk assessment that it observes when considering whether to initiate a TP enquiry (i.e. the ZRA would expect a taxpayer acting reasonably to go to greater lengths in relation to making records and evidence available where risks are higher than it would where the risks are lower).

In terms of the general penalty provisions, Section 98 of the Zambia Income Tax Act, the Commissioner-General of the ZRA may levy a fine not exceeding 2,000 Zambian kwachas (ZMW) (approximately 270 United States dollars [USD]) (ZMW 1 = USD 7.4) or subject the taxpayer to imprisonment for a term not exceeding 12 months, or may levy and subject the taxpayer to both the fine and imprisonment. Further, under Section 100 of the Zambia Income Tax Act, a penalty for an incorrect return may be levied on the amount of income understated or expenses overstated. The penalty charged on the amount of income understated or expenses overstated may be levied at 17.5% in the event of negligence, 35% in the event of wilful default and 52.5% in the event of fraud. In addition, the late payment of tax is subject to a penalty of 5% per month or part thereof from the payment due date. Interest is also levied on the outstanding tax payable amount at the Bank of Zambia discount rate plus 2% (currently this interest rate is approximately 12.5% per annum).

Documentation

The Zambia draft PN states, generally, that the following records should be kept to avoid exposure to penalties:

- primary accounting records
- tax adjustment records, and
- records of transactions with associated businesses.

Further, in accordance with Section 97C of the Zambia Income Tax Act, the burden of proof lies with the taxpayer to demonstrate that the TP policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's-length standard.

As per the Zambia draft PN, the ZRA considers that as a step towards discharging the burden of proof, it is in the taxpayer's best interests to:

- develop and apply an appropriate TP policy
- determine the arm's-length conditions as required by Section 97A of the Zambia Income Tax Act
- maintain contemporaneous documentation to support the policy and the arm's-length conditions in points (a) and (b) above, and
- voluntarily produce the documentation when asked.

On another note, the Minister of Finance and National Planning in his 2014 budget speech indicated that measures are to be introduced to strengthen existing anti-avoidance provisions and to enable him to prescribe Transfer Pricing documentation rules. Therefore, the Government is expected to issue prescribed guidelines on TP documentation soon. The expectation is that these rules will be in line with OECD Guidelines.

Transfer pricing controversy and dispute resolution

Tax audit procedures

As per the Zambia draft PN, the ZRA has adopted the arm's-length principle and refers to the OECD Transfer Pricing Guidelines for Multinational Enterprises (MNEs) and Tax Administrations in conducting a TP investigation. All MNEs are potential targets. The ZRA follows no specific procedure when conducting a tax audit; generally, the company is notified and requested to provide supporting documentation. The ZRA prefers that the company under enquiry also provide the comparables. The ZRA then looks at the information provided and the comparables, and negotiates accordingly.

Resources available to the tax authorities

The Domestic Taxes Department within the ZRA is responsible for conducting corporate tax enquiries. Where appropriate, the Large Tax Payer Office also participates in complex tax enquiries including TP-related cases. ZRA has made significant investment towards capacity building, aimed at improving the authority's understanding of TP practices. Investment has been made in developing specialist expertise within the ZRA through training locally and abroad. ZRA is also working closely with a number of parties including other tax authorities, to build capacity in this regard.

Liaison with other authorities

When conducting an investigation, the ZRA may liaise with the foreign revenue authority of the foreign company involved in the related-party transaction. To this end, the principle tax acts have been amended to include exchange of information provisions within domestic law. This is in addition to already existing exchange of information articles in more recent double tax agreements. The ZRA may further seek advice and guidance from the revenue authorities providing general TP support.

Mutual agreement procedures (MAPs)

Lack of experience means that competent authority claims or reliance on MAPs to resolve disputes are problematic.

Advance pricing agreements (APA)

As per the Zambia draft PN, the ZRA does not currently intend to adopt an APA procedure, but will keep this decision under review as taxpayers and the ZRA gain TP experience.

Comparison with OECD Guidelines

Zambia is not a member of the OECD, but maintains observer status. The ZRA have stated in the draft PN that they regard OECD Guidelines as international best practice.

Zambia

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Zimbabwe

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Overview

Zimbabwe introduced transfer pricing (TP) legislation in April 2014 with the application of the legislation being applied retrospectively from 1 January 2014. The new legislation requires the supply of goods and services between associated entities to be reflected at arm's length for both cross-border and domestic transactions. No guidance has yet been provided by the Zimbabwe Revenue Authority (ZIMRA) regarding the practical application of TP. The Organisation for Economic Co-operation and Development (OECD) Guidelines on TP is most likely going to be adopted in determining the arm's-length price.

No TP disputes have yet been taken to court, neither are there any disputes that have yet been settled before going to court. Before the introduction of the TP legislation, TP adjustments were raised by ZIMRA using the general anti-avoidance rules. Additionally, companies with offshore investments have had TP adjustments by ZIMRA based on the opportunity cost of investing the funds locally. It is anticipated that ZIMRA will increase the number of TP audits following the return of TP specialists who had been sent to Australia, New Zealand and South Africa on a secondment basis.

Country	**Zimbabwe**
OECD member?	No
TP legislation	
Are there statutory TP documentation requirements in place?	No
Does TP legislation adopt the OECD Guidelines?	Yes
Does TP legislation apply to cross-border inter-company transactions?	Yes
Does TP legislation apply to domestic inter-company transactions?	Yes
Does TP legislation adhere to the arm's-length principle?	Yes
TP documentation	
Can TP documentation provide penalty protection?	No
When must TP documentation be prepared?	No specific documentation requirements.
Must TP documentation be prepared in the official/local language?	Yes

Zimbabwe

Country	Zimbabwe
Are related-party transactions required to be disclosed on the tax return?	No
Penalties	
Are there fines for not complying with TP documentation requirements?	Yes, if taxpayer cannot prove arm's length.
Do penalties or fines or both apply to branches of foreign companies?	Yes
How are penalties calculated?	As a percentage of the tax adjustment.

Introduction

Transfer pricing legislation was introduced in April 2014 and will be applied retrospectively with effect from 1 January 2014. No specific guidelines have been provided by ZIMRA, even though it seems the OECD Guidelines will be followed. A few audits have been conducted by ZIMRA so far with no specific industry/sector focus. At the moment, there are no advance pricing agreements (APAs) in place. Zimbabwe has entered into double tax treaties (DTTs) with 12 countries and these include: Bulgaria, Canada, France, Germany, Malaysia, Mauritius, Netherlands, Norway, Poland, South Africa, Sweden and the United Kingdom. All the DTTs provide for mutual agreement procedures (MAPs), even though in practice, there are hardly any cases to our knowledge where MAPs have been relied upon to resolve disputes.

Legislation and guidance

The new TP legislation includes under Section 2A and 2B, a definition of persons deemed to be associates and a definition of persons deemed to control a company, respectively. In addition, the new Section 98A gives the Commissioner the power to adjust the taxable income of the taxpayer and the associate to prevent any reduction in tax payable as a result of income splitting. Income splitting refers to the transfer of income or property (with the result that the associate receives or enjoys the income from that property) directly or indirectly to an associate for the sole or main reason of lowering tax payable upon incomes of the taxpayer and the associate.

Section 98B of the TP legislation deals with transactions between associates, employers and employees. The Commissioner has the right to distribute, apportion or allocate income, deductions or tax credits between the associates or persons, as is considered necessary, to reflect the taxable income that would have accrued to them in an arm's-length transaction. Income accruing from any transfer or licence of intangible property between associates or persons in an employer–employee relationship may also be adjusted by the Commissioner to adequately reflect the income attributable to that property. These adjustments may entail recharacterising the source of income and the nature of any payment or loss as revenue, capital or otherwise.

Zimbabwe has always had statutory rules dealing with thin capitalisation for both cross-border and domestic financing. These rules deny a deduction relating to expenditure in servicing debt to the extent that such debt causes the person to exceed a debt to equity ratio of 3:1. The terms debt and equity have not been defined in the legislation and no regulations are available. The disallowed amounts may be deemed to be a dividend and subject to withholding tax. However, the enforcement of the thin capitalisation legislation by ZIMRA has not been as aggressive as expected in the last few years.

Deductions of management and administration fees payable to associated entities are also capped. The deduction is limited to such expenses not exceeding 1% (for a company already in production) and 0.75% (prior to production) of total tax-deductible expenses.

Penalties

There are no special penalty rules that apply in relation to additional tax arising from TP adjustments. Normal penalties of up to a maximum of 100% of the principal tax and late payment interest of 10% per annum apply.

Documentation

There is no specific requirement to prepare TP documentation. Taxpayers are, however, expected to readily demonstrate that transactions are at arm's length should an audit be conducted. There are also no specific disclosure requirements of the nature or details of transactions with associated entities on the current return. ZIMRA has, to date, not issued any documentation guidelines. It is, as a result, not clear whether global documentation is acceptable or if it should be localised. We, however, recommend that localised documentation is maintained. Taxpayers should also ensure that the documentation is reviewed annually (at the time that returns are submitted) to ensure consistency with local legislation, especially where there may have been changes to the taxpayers' operations.

It remains to be seen how ZIMRA will deal with the issue of comparables, mainly due to the fact that no local country comparables are available as there are no local databases with readily available local company information. Availability of information for public companies is limited to published interim and final annual financial statements. Private companies' information is generally not available. In addition, there has not been any guidance issued regarding adjustments to be made to foreign comparables should ZIMRA decide to use that option.

Transfer pricing controversy and dispute resolution

The TP audit environment and process is not yet clear as the legislation is relatively new. ZIMRA, however, expects taxpayers to have TP documentation available, even though there is no requirement to submit TP documentation when returns are submitted. The burden of proof is therefore on the taxpayer to prove that associated party transactions are at arm's length and that the TP policy complies with the relevant rules in accordance with Section 63 of the Income Tax Act.

No TP disputes have yet been taken to court, neither are there any disputes that have yet been settled before going to court.

At the moment, there are no APAs in place. Legislation provides for advance tax rulings, but we are not aware of any such rulings being issued to date.

There is no information available on the use of competent authority relief or any other dispute resolution avenues. Mutual agreement procedures for cross-border disputes are, however, provided for in cases where Zimbabwe has tax treaties, even though in practice there are hardly any cases to our knowledge where MAPs have been relied upon to resolve disputes.

Before the introduction of the TP legislation, TP adjustments were raised by ZIMRA using the general anti-avoidance rules. Additionally, companies with offshore investments have had TP adjustments by ZIMRA, based on the opportunity cost of investing the funds locally. Transfer pricing audits are expected to be on the rise following the return of TP specialists who had been sent to Australia, New Zealand and South Africa on a secondment basis.

Comparison with OECD Guidelines

There are no known differences between the TP rules in Zimbabwe and the OECD TP Guidelines. The TP provisions are new and no guidelines have yet been issued by ZIMRA on the determination of the arm's-length principle. Indications, however, seem to point towards the adoption of the OECD model. Comparisons can only be made after we have made assessments of how ZIMRA is applying the new TP rules in practice.

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Helping you manage your transfer pricing risk

There have continued to be significant changes in the area of transfer pricing since our prior edition, with several new countries implementing either formal or informal transfer pricing documentation requirements and significant regulatory changes in many other countries over the past twelve months. Most significantly, the deliverables released as part of the OECD's Base Erosion & Profit Shifting (BEPS) Action Plan have resulted in the need for companies to re-evaluate and reconsider their transfer pricing strategies in light of the proposed new guidance.

International Transfer Pricing 2015/16, now in its 15th edition is an easy to use reference guide covering a range of transfer pricing issues in nearly 100 territories worldwide. Written by local PwC transfer pricing specialists in each country, the book provides practical advice on developing a coherent and robust transfer pricing policy that is responsive to today's climate of change.