



# Arm's Length Standard

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## In this issue:

Brazil Issues New Transfer Pricing Regulations .....	1
Canada Updates Administrative Guidance with Two New Transfer Pricing Memoranda .....	3
Australia's Evolving Transfer Pricing Landscape .....	6
Greece Modernizes Transfer Pricing Regime .....	15
Brazil Amends Transfer Pricing Rules on Financial Transactions .....	17
Serbia Amends Transfer Pricing Legislation .....	19

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## Brazil Issues New Transfer Pricing Regulations

Following the enactment of Brazil's new transfer pricing rules in September 2012, the Brazilian revenue services, on December 31, 2012, published Normative Ruling 1,312. The purpose of NR 1,312 is to provide instructions to tax inspectors and taxpayers on how to apply the country's new transfer pricing rules set forth by Law 12,715. Although NR 1,312 is generally consistent with Law 12,715, it provides significant details associated with the application of Brazilian transfer pricing rules. Although Law 12,715 applies to fiscal years starting on or after January 1, 2013 (taxpayers may opt to apply the new rules from fiscal year 2012), some of the provisions of NR 1,312 are effective for fiscal year 2012.

The Brazilian government also enacted Law 12,766 on December 28, 2012. Law 12,766 provides new transfer pricing rules for financial transactions. The new rules on financial transactions are not regulated by NR 1,312. We expect the Brazilian revenue service to issue an additional ruling addressing the new transfer pricing rules on financial transactions soon.

The key points of NR 1,312 include the following:

### Changes to the Safe Harbor Rules on Outbound Transactions

Since the enactment of the Brazilian transfer pricing rules in 1996, the Brazilian revenue services have provided some flexibility to taxpayers that enter into eligible outbound intercompany transactions (outbound transactions carried out with parties located in jurisdictions Brazil does not consider tax havens or favorable tax jurisdictions) through safe harbor rules on outbound transactions. Safe harbor rules consist of two independent thresholds allowing taxpayers not to apply a transfer pricing method to analyze the reasonableness of their outbound transactions' pricing. The thresholds are based on profitability and/or representativeness of the relevant intercompany outbound transactions. The table below compares the old safe harbor rules (applicable to all fiscal years before 2012) and the new rules (in principle applicable to any fiscal year starting on or after January 1, 2012). Please note that under NR 1,312 commodity product transactions are not eligible to benefit from the safe harbor criteria.

Thresholds	Applicability	
	All fiscal years before 2012	In principle applicable to fiscal years starting on or after January 1, 2012
Revenue representativeness safe harbor	Transactions are not subject to the Brazilian transfer pricing rules if the net revenue for intercompany outbound transactions is below 5% of the total net revenue for the year under analysis.	Same as before.
Profitability safe harbor	Taxpayers earning pretax margins in intercompany outbound transactions equal or above 5% are not subject to the Brazilian transfer pricing rules, based on the financial data for the three most recent years (current year, plus two preceding years). Exceptions were available for some years allowing the calculation on a single-year basis.	The pretax margin threshold was increased from 5% to 10%. The 10% margin should be determined based on the financial data for the three most recent years (current year plus two preceding years). Additionally, the profitability safe harbor will not apply to taxpayers entering into outbound intercompany transactions whose net revenue from related parties represents more than 20% of the total outbound transaction net revenue.

As shown above, NR 1,312 changes the profitability safe harbor rules significantly, affecting taxpayer's ability to pass muster under the threshold. Theoretically, because safe harbor rules are considered a "privilege," these can be changed by the Brazilian revenue services without further notice. Changing the rules in the last business day of the year and requiring their application for fiscal year 2012 will most likely trigger legal considerations, as this change may result in an immediate increase in the tax burden.

We expect this to become a major topic for discussion within the next months.

Taxpayers that fail to meet one of the existing safe harbor rules are subject to the Brazilian transfer pricing rules on outbound transactions. In other words, taxpayers will need to apply one of the available transfer pricing methods to analyze and assess the reasonableness of their intercompany prices. Given the limitations of the Brazilian transfer pricing rules, most taxpayers would be subjected to the cost plus 15 percent margin (CAP) method on outbound transactions.

#### Application of the New Transfer Pricing Methods for Commodity Transactions

Law 12,715 introduced two additional transfer pricing methods to the existing Brazilian methods: the commodity exchange import price and the commodity exchange export price for inbound and outbound transactions with commodities, respectively. Under these methods, the basis for comparison is the average commodity exchange price for the relevant items, adjusted for upward or downward spreads. For commodity products not negotiated in commodity exchanges, Law 12,715 also allowed the use of prices obtained from reputable market institutions.

NR 1,312 provides a nonexhaustive list containing 21 classes of products that the Brazilian tax authorities consider commodity products. These include cotton, meat, soy, orange juice, petroleum, gold, iron, and steel. NR 1,312 goes further, indicating that any products negotiated in specific mercantile exchanges (listed in the annex to the ruling) will be deemed commodity products. Finally, the NR lists institutions the Brazilian tax authorities consider reputable and that can be used as source for obtaining commodity products' prices.

#### Application of Transfer Pricing Rules to Back-to-Back Transactions

Less risk-adverse taxpayers and tax practitioners have historically argued the Brazilian transfer pricing rules did not apply to intercompany back-to-back transactions to the extent products did not enter or leave the country, therefore not configuring import and export transactions, regardless the fact that title changed hands in back-to-back transactions. In November 2012, addressing a taxpayer's question on the application of the Brazilian transfer pricing rules to back-to-back transactions, the Brazilian revenue services indicated those should apply. Consistent with the Brazilian tax authorities' position, NR 1,312 specifically indicates that back-to-back transactions are subject to the local transfer pricing rules.

## Margin of Difference

As general rule, the Brazilian transfer pricing legislation calls for the comparison of two prices: the practiced price (generally the actual transaction price) and the parameter price (the price derived from the application of one of the available transfer pricing methods). Whenever the parameter price is lower than the practiced price in an outbound transaction, or if the parameter price is higher than the practiced price in an inbound transaction, the difference represents an adjustment to the Brazilian tax basis. The Brazilian transfer pricing rules have historically provided that whenever the difference between both prices is equal or less than five percent, no adjustment is necessary. NR 1,312 retains the five percent threshold, and applies it to all available transfer pricing methods except those for commodity transactions. Under NR 1,312 the margin of difference criteria applies for commodity transactions, but the difference between practiced and parameter prices is limited to 3 percent.

## Conclusion

NR 1,312 contains 60 articles and three annexes. It is a long and detailed document designed to address the major topics associated with an application of the Brazilian transfer pricing rules. The ruling is generally consistent with the recently amended Brazilian transfer pricing rules, with the exception that it does not address the newest transfer pricing rules on financial transactions. The language in the ruling is unclear at times, which will create some confusion for taxpayers and the tax authorities that will ultimately enforce the rules. An unexpected change brought by the ruling is the increase in the threshold for meeting the profitability safe harbor criteria, and the inclusion of an additional condition for qualifying under the profitability safe harbor criteria. We expect this to become a controversial issue among taxpayers and the tax authorities.

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## Canada Updates Administrative Guidance with Two New Transfer Pricing Memoranda

The Canada Revenue Agency on October 30, 2012, issued its 13th Transfer Pricing Memorandum-(TPM). *TPM-13 Referrals to the Transfer Pricing Review Committee* provides updated guidance on the CRA's administrative procedures related to referrals to the Transfer Pricing Review Committee (TPRC) and replaces and cancels guidance on the same matter previously issued in *TPM-07* on August 2, 2005. On October 31, 2012, the CRA additionally issued *TPM-14 2010 Update of the OECD Transfer Pricing Guidelines*. TPM-14 provides an overview of the significant changes made to the 2010 version of the Organization for Economic Cooperation and Development (OECD) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and their position regarding these changes.

### Background Facts

Transfer Pricing Memoranda (TPMs) issued by the CRA do not have the force of law, but along with Information Circular 87-2R: *International Transfer Pricing (IC87-2R)*, are key documented sources of guidance to taxpayers regarding the CRA's views and administrative positions on a number of transfer pricing-related topics. TPM-13 and TPM-14 represent the first new formal guidance issued by the agency since its release of TPM-12 Accelerated Competent Authority Procedure (ACAP) in 2008.

### TPM-13: Referrals to the Transfer Pricing Review Committee (TPRC)

TPM- 13 makes clear that all proposed reassessments to recharacterize a transaction under paragraphs 247(2)(b) and (d) of the Income Tax Act or a penalty levied under subsection 247(3) of the ITA must be first referred to the TPRC to ensure fairness and consistency in the application of the law.

In addition to clarifying language previously used in respect of the issuance of an assessment or levy of a penalty, TPM-13 revises or provides new guidance related to:

- The treatment of qualified cost contribution arrangements (QCCAs);
- TPRC membership;
- The process for penalty referrals;
- The process for recharacterization referrals; and
- The role of the large case manager.

### **Treatment of QCCAs**

TPM-13 clarifies, for cases involving cost contribution arrangements (CCAs), that only those adjustments that exceed the penalty threshold set forth in subsection 247(3) will be considered for a penalty and therefore require referral to the TPRC. TPM-13 further clarifies that in computing the penalty threshold for audit issues involving CCAs, consideration will be given to the quantum of the adjustment in combination with other transfer pricing adjustments.

### **TPRC Membership**

Much of TPM-07's commentary on who shall form the committee has been updated in TPM-13, primarily to reflect recent internal CRA reorganizations and related naming conventions. TPM-13 also formalizes the inclusion of a manager from the Aggressive Tax Planning Division and a senior official from the Tax Policy Branch of the Department of Finance Canada as participants on the committee for final consideration of cases involving recharacterization.

### **Process for Penalty Referrals**

The updated guidance clarifies that taxpayers will receive notification of any transactions that may be subject to a subsection 247(3) penalty in a separate draft penalty referral report, rather than as part of the proposal letter. TPM-13 is also more explicit about what constitutes a reasonable amount of time (generally 30 days) for taxpayers to make representations with respect to the potential penalty, and states that such representations will be included in the penalty referral report made to the TPRC by the auditor.

### **Process for Recharacterization Referrals**

Overall, the process outlined in TPM-13 is broadly similar to that previously set forth in TPM-07. Assessments involving a recharacterization will be considered in three stages, and auditors must first make a taxpayer aware of their intent to pursue a recharacterization. The TPRC, after a review of representations from the auditor and the taxpayer, must confirm that a recharacterization is appropriate in the circumstances before a formal proposal to recharacterize can be issued. However, TPM-13 no longer explicitly states the need for taxpayers to be made aware of the transactions and the facts that are being taken into consideration by the auditor during the initial consideration stage, and requires only that taxpayers be notified following approval by the TPRC after initial consideration. TPM-13 no longer requires that a formal referral to the TPRC be made at least three months before the statute-barred period.

### **Role of the Large Case Manager**

TPM-13 no longer includes the guidance found in TPM-07 that all audit issues for large file cases, including potential application of the transfer pricing penalty or recharacterization provisions of the Income Tax Act, should be routed through the large file case manager.

### **TPM-14: 2010 Update of the OECD Transfer Pricing Guidelines**

Released on September 27, 1999, IC87-2R provides guidance on the application of the arm's length principle as per the requirements outlined in section 247 of the Income Tax Act. It contains several references to the OECD transfer pricing guidelines as they were read at the time of release. With the publication of the updated OECD guidelines on July 22, 2010, the CRA has issued TPM-14, which provides a summary of the key changes made to the OECD guidelines and the CRA's position with respect to those changes.

In addition to confirming the CRA's endorsement of the application of the arm's length principle and the 2010 version of the OECD transfer pricing guidelines, TPM-14 stresses that the 2010 version of the OECD guidelines is a "clarification and elaboration" of the previous version, and is therefore applicable to all years available for audit and to all treaties, including those concluded before the release of the 2010 OECD guidelines.

Key changes to the OECD guidelines identified and commented upon by the CRA include:

- The adoption of the most appropriate method;
- Application of transactional profit methods;
- Performing a comparability analysis; and
- Transfer pricing aspects of business restructuring.

### **The Most Appropriate Method**

The 2010 version of the OECD transfer pricing guidelines no longer prescribes a strict hierarchy of transfer pricing methods, stressing that the selection of the "most appropriate" transfer pricing method will depend on the facts and circumstances of a particular case, including the quality of the data available. While holding the view that this change does not necessarily deemphasize the natural hierarchy, the CRA acknowledges that what is truly relevant is the degree of comparability under each of the methods and the availability and reliability of the data.

### **Application of the Transaction Profit Methods**

The 2010 OECD transfer pricing guidelines include additional guidance in Chapter II on the application of the transactional profit methods, including specific criteria to consider when selecting net profit indicators, determining net profit, weighing net profit, the application of the Berry ratio, and employing the profit split methodology, all of which the CRA believes will provide "valuable expanded guidance" on these matters.

### **Performing a Comparability Analysis**

Chapter III of the 2010 OECD transfer pricing guidelines contains new guidance on performing a comparability analysis. TPM-14 notes that while the Income Tax Act does not prescribe a particular process for undertaking a comparability analysis, it endorses the OECD's "typical process" and stresses the need for taxpayers to make reasonable efforts to determine and use arm's length prices or allocations when pricing their intercompany transactions.

### **Transfer Pricing Aspects of Business Restructuring**

Arguably the most significant change to the 2010 version of the OECD transfer pricing guidelines is the expanded guidance on business restructurings provided in Chapter IX of the guidelines. Most importantly, TPM-14 confirms and publicly sets forth the CRA's views regarding contractual allocation of risks, appropriate compensation for the restructuring, and the treatment of post-restructuring intercompany transactions.

### **Observations**

Regarding referrals to the TPRC, the new guidance makes explicit that taxpayers should be given a copy of the referral report with a reasonable period of time to respond. Consequently, taxpayers should expect transparency regarding their interactions with the TPRC. Specifically in the case of recharacterization referrals, the inclusion of individuals from the Department of Finance and the Aggressive Tax Planning Division of the CRA should bring a broader perspective to the committee and help to ensure fairness and consistency to proposals to recharacterize a transaction under paragraphs 247(2)(b) and (d) of the ITA.

Unfortunately, other revisions suggest that taxpayers may only learn of the CRA's intent to recharacterize after the TPRC's first consideration. This may result in the loss of some opportunities to clarify the nature of certain transactions at the very earliest stage of an audit.

TPM-13's new-found silence regarding timely referrals to TPRC could in some cases result in incomplete or improper referrals to TPRC, while in other cases result in insufficient time for the TPRC to well consider a referral. In either case, when

a taxation year is about to become statute-barred, it is almost certain to place an additional compliance burden on taxpayers, and may limit their ability to respond to the TSO's representations.

TPM-14 restates the CRA's endorsement of the revised 2010 OECD transfer pricing guidelines and the arm's length principle previously articulated in Information Circular IC87-2R International Transfer Pricing regarding the 1995 OECD guidelines.

TPM-14 expresses in detail the CRA's concurrence with Chapter 3 on performing a comparability analysis and Chapter 9 related to the transfer pricing aspects of business restructurings. Taxpayers may infer some insight into future examination approaches and potential areas of contention under a CRA transfer pricing audit.

In TPM-14, the CRA makes clear that while the 2010 transfer pricing guidelines bring forward the notion of choosing the most appropriate method in the circumstances, the hierarchy of methods remains valid. Consequently, taxpayers can expect the CRA to continue to consider the hierarchy in the selection of methods and exhibit a preference for methods higher in the hierarchy, when their use will yield the same or better reliability.

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## Australia's Evolving Transfer Pricing Landscape

Australia's transfer pricing regime is undergoing its most fundamental change in 30 years, creating unprecedented interest in transfer pricing from corporations, professional bodies, government agencies, and the media.

The Australian changes arise from the following sequence of initiatives:

<b>September 2012</b>	Enactment of retrospective "treaty equivalent" transfer pricing laws
<b>May 2012 and October 2012</b>	The Board of Taxation's review of tax arrangements applying to permanent establishments (hereinafter: PEs)
<b>October 2012</b>	The Inspector General of Taxation's review of the Australian Taxation Office's (hereinafter: ATO) management of transfer pricing matters
<b>November 2012</b>	Treasury's release of draft, prospective transfer pricing rules for consultation
<b>December 2012</b>	Treasury's formation of a specialist reference group on the taxation of multinational corporations (hereinafter: MNCs) in Australia
Taxpayers' obligations to make significant transfer pricing-related disclosures to the ATO on a new International Dealings Schedule (hereinafter: IDS)	

Changes to Australia's transfer pricing landscape are not occurring in a vacuum, and must be viewed in light of global transfer pricing developments and the global economic climate after the global financial crisis. More and more countries are introducing and modifying their own transfer pricing laws, and there has also been substantial transfer pricing activity at the Organization for Economic Cooperation and Development and the United Nations. Developing transfer pricing jurisprudence and growing media focus on MNCs' transfer pricing practices have also been factors.

A number of major MNCs have made headlines in the financial media for allegedly structuring their global operations to minimize taxes. The general flavor of these articles is reflected by one UK newspaper's assertion that "...multinationals are using structures and exploiting current tax legislation to move offshore profits that are clearly generated from economic

activity in the UK.<sup>1</sup> This media campaign has reinforced the resolve of revenue authorities and governments to use transfer pricing and general anti-avoidance rules to protect their tax bases from erosion.

In many ways, the increased global focus on transfer pricing means that Australia’s transfer pricing reforms are well timed. In addition, the policy intent behind the reforms is welcome. Specifically, the Australian government’s goal is to “modernize Australia’s transfer pricing regime, aligning the domestic law with international best practice and improving the integrity and efficiency of the tax system ... to help Australia protect its tax base.”<sup>2</sup>

The Australian Taxation Office (ATO), tasked with administering the new transfer pricing provisions, has assured taxpayers that it will be “business as usual” regarding its transfer pricing compliance enforcement. However, given the intense scrutiny on transfer pricing, MNCs operating in Australia are well advised to intensify their transfer pricing governance.

## Australian Transfer Pricing -Timeline of Activity

### 1990s to mid-2000s

Australia’s original transfer pricing legislation [Division 13 of the Income Tax Assessment Act 1936] was introduced in 1982, and has until very recently remained unchanged. The law focuses on ensuring that Australian taxpayers receive arm’s length consideration (and do not pay greater than arm’s length consideration) for the supply or acquisition of property in the context of international related-party dealings.

The ATO published a suite of transfer pricing taxation rulings<sup>3</sup> in the 1990s/early 2000s, to assist taxpayers to interpret and apply Division13:

Taxation Ruling	Description
TR 92/11	Application of the Division 13 transfer pricing provisions to loan arrangements and credit balances
TR 94/14	Basic concepts underlying division 13
TR 95/23	Procedures for bilateral and unilateral advance pricing arrangements <sup>4</sup>
TR 97/20	Arm’s length transfer pricing methodologies for international dealings
TR 98/11	Documentation and practical issues associated with setting and reviewing transfer pricing in international dealings
TR 98/16	International transfer pricing penalty tax guidelines
TR 1999/1	International transfer pricing for intra-group services
TR 2001/11	Operation of Australia’s permanent establishment attribution rules

### 2007/09

As noted above, Division 13 has remained unchanged since 1982. No substantive transfer pricing matters were tried before the Australian courts until 2007 and 2008. Two legal issues remained unresolved and untested:

- The use of profit-based methods in the context of Division 13; and
- Whether Australia’s double tax treaties provided a separate taxing power.

The *Roche* case<sup>5</sup> was the first substantive transfer pricing case to test certain technical aspects of Division 13 in Australia. Justice Downes expressed a clear preference for an analysis of “prices” rather than “profits,” based on a strict interpretation

<sup>1</sup> “Google, Starbucks & Amazon’s Tax Arrangements are ‘Immoral,’ say MPs,” *London Evening Standard*, 3 December 2012, (<http://www.standard.co.uk/business/business-news/google-starbucks--amazons-tax-arrangements-are-immoral-say-mps-8375121.html>)

<sup>2</sup> The Hon David Bradbury, “Progressing Reforms to Australia’s Transfer Pricing Rules” (Media Release, No. 144, 22 November 2012). Note this is more critical given the recommendations to reduce the Australian corporate income tax rate according to the Business Tax Working Group’s recent recommendations. Reforms to broaden Australia’s Part WA ITAA 1997 (general anti-avoidance provisions) also are progressing parallel to the transfer pricing reforms.

<sup>3</sup> Taxation rulings are published statements expressing the ATO’s opinion of how a provision of tax law applies, or would apply, to taxpayers generally, and are legally (and administratively) binding on taxpayers.

<sup>4</sup> Since withdrawn, as discussed below.

of the wording in Division 13. The *SNF* case,<sup>6</sup> Australia's highest-profile substantive transfer pricing case to date, was next to be litigated. The court held that the language of Division 13 was limited to transactional consideration, ruling in favor of the taxpayer that the burden of proof was limited to demonstrating that prices paid for imported products were not excessive.

As discussed below, the ATO's appeals of the *SNF* decisions were heard in 2010 and 2011. The ultimate outcome of the case (in the taxpayer's favor) was the impetus for the recent legislative reforms introduced in Australia.

## 2010/2011

Financing transactions came squarely under the microscope in 2010, with the ATO releasing Taxation Ruling TR 2010/7 on the interaction of the transfer pricing and thin capitalization provisions. Under this ruling, the ATO contended that despite a safe harbor debt amount being afforded to Australian taxpayers under the thin capitalization provisions in Division 820 of the ITAA 1997, the transfer pricing rules could be applied to: (i) hypothesize an arm's length capital structure for an Australian subsidiary and thus a notional arm's length amount of debt; (ii) price the hypothetical arm's length debt amount; and (iii) reprice the Australian subsidiary's *actual* amount of debt. Not surprisingly, this ruling was met with controversy and concern by taxpayers and practitioners.

The ATO's focus on taxpayers shifting functions, assets, and/or risks out of Australia culminated in the release of Taxation Ruling TR 2011/1 on business restructurings.<sup>7</sup> In that ruling, the ATO set out its expectations as to what taxpayers should have considered prior to undertaking a restructuring, including threshold commerciality requirements and the type of detailed documentation taxpayers should have in place to support their transfer pricing pre- and post-restructuring. Again, the business community expressed concerns over this ruling, arguing that the ATO could not seek to recharacterize or challenge decisions made in the ordinary course of business or for the best interests of the taxpayer's group.

In June 2011, the Full Federal Court heard the ATO's final appeal in the *SNF* case. The ATO focused on the taxpayer's poor bottom line profitability and the fact that it had incurred operating losses for 11 years as the basis for adjustments by applying a profit-based method, the transactional net margin method (TNMM). The ATO's bid to apply the TNMM to effectively reduce the pricing of *SNF* Australia's international related-party chemical purchases by increasing its profit level to an average net positive operating margin in line with similar third-party distribution entities was disallowed, with the court accepting evidence that *SNF* Australia's sustained losses were caused by commercial factors.

The ATO's loss in the *SNF* case effectively highlighted how certain aspects of the ATO's approach to transfer pricing cases were based on questionable legal authority. Three key considerations arose from the case, which incidentally have all been addressed in the subsequent legislative transfer pricing reforms:

- The relevance of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Taxation Administrations in Australia;
- The ability to use profit-based pricing methods, such as the TNMM, under Australia's transfer pricing laws, and whether Division 13 authorizes the application of any method other than the comparable uncontrolled price (CUP) method;
- Whether the application of the arm's length principle involves a "commercial sense" requirement, particularly when data on comparable uncontrolled transactions is unavailable.<sup>8</sup>

Only months after the decision on the Full Federal Court appeal was handed down, the Australian government announced its plans to overhaul Australia's transfer pricing provisions on 1 November 2011.<sup>9</sup>

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<sup>5</sup> *Roche Products Pty Ltd v Commissioner of Taxation* [2008] AATA 639.

<sup>6</sup> *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2010] FCA 635; with 2 appeals: *SNF (Australia) Pty Ltd v Commissioner of Taxation (No 2)* [2010] FCA 823; and *Commissioner of Taxation v SNF Australia Pty Ltd* [2011] FCAFC 74.

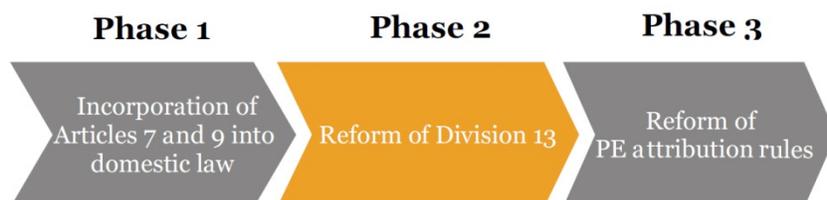
<sup>7</sup> The content of TR 2011/1 is largely an adaptation of the commentary in Chapter IX of the OECD transfer pricing guidelines on business restructurings.

<sup>8</sup> TR 2010/7 and TR 2011/1 in particular rely heavily on the "commercial sense" requirement, which forms an integral part of the ATO's approach to transfer pricing, and calls for analyzing whether the outcomes of a taxpayer's transfer prices make commercial sense in its circumstances, with bottom line profitability being relevant to assessing this. It became difficult to see how the ATO could sustain this view in light of the *SNF* decision.

## Australia’s Legislative Transfer Pricing Reforms – 2012

The government sought to reform the transfer pricing rules to bring them into line with international best practices, recognizing that Division 13 was significantly outdated and that the resulting inconsistencies with current international standards were not in Australia’s best interests. The stated policy objectives of the reforms therefore included both limiting the erosion of the Australian tax base through profit shifting, and also ensuring that Australia’s transfer pricing rules do not diminish it’s attractiveness as a destination of investment and new business activity.

The reform of Australia’s transfer pricing rules was structured to take place over three key phases:



The following is an overview of the Phase 1 and 2 reforms:

Retrospective Changes	Prospective Changes
<ul style="list-style-type: none"> <li>New Subdivision 815-A <i>ITAA 1997</i> will prescribe treaty equivalent cross-border TP rules with retrospective effect (income years commencing 1 July 2004 onwards).</li> </ul>	<ul style="list-style-type: none"> <li>New provisions in <i>ITAA 1997</i> replacing the current Division 13 in <i>ITAA 1936</i></li> <li>New definition of the arm’s length principle</li> <li>Legislating the OECD TP Guidelines</li> <li>New discretionary powers for the Commissioner</li> <li>Self-assessment provision</li> <li>Documentation requirements and penalties</li> <li>Time limits for transfer pricing adjustments</li> <li>New rules for profit attribution to PEs</li> </ul>

### Phase 1 – Challenges to Retrospectivity and Broadness of ATO’s Powers

This phase was marked by the enactment in September 2012 of “treaty-equivalent cross-border transfer pricing rules” via Subdivision 815-A of the *ITAA 1997*. The primary purpose of the Phase 1 reforms was to ensure that the transfer pricing articles in Australia’s tax treaties can be applied as an assessment power independent of Division 13. The outcomes under the transfer pricing articles of Australia’s treaties (Articles 7 and 9) were legislated into Australia’s transfer pricing provisions. Subdivision 815-A does not give the ATO any more power to make transfer pricing adjustments than it believes it already had under existing law. This is consistent with the government’s repeated statements that it is only “clarifying” the existing law as regards the treaty transfer pricing articles providing an assessment power independent of Division 13.

Key points to note regarding Subdivision 815-A are outlined below:

- Legislative framework** – Australia’s transfer pricing rules now comprise three sets of provisions: Subdivision 815-A, the existing laws in Division 13, and the treaty transfer pricing articles. All apply fundamentally the same arm’s length principle, although differences in wording between Division 13 (transactional basis) and the other provisions (looking at profit outcomes more broadly) create a potential for differing outcomes.
- Retrospectivity** – Despite significant debate and controversy, Subdivision 815A applies retrospectively from 1 July 2004. The major impact of the retrospective law falls on taxpayers with ongoing ATO transfer pricing audits. The ATO has indicated that it has 40 such cases involving transfer pricing adjustments worth A \$1.9 billion. The ATO now has legislative backing for what were previously only arguable views. Other taxpayers potentially affected by the law’s retrospective application are those at risk of an ATO audit of the 2004 to 2012 years. Factors that may

<sup>9</sup> In the Press Release announcing the proposed reforms [“Robust Transfer Pricing Rules for Multinationals,” (Press Release No. 145, 1 November 2011)], the Hon Bill Shorten MP specifically noted the intention to introduce “amendments to the law to clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in the domestic law.”

place taxpayers at risk of an ATO audit include persistent losses, global restructurings, or significant related-party debt expenses.<sup>10</sup>

- **Transfer pricing benefit** – The commissioner of taxation is able to disallow a “transfer pricing benefit” received by an Australian taxpayer in relation to a cross-border related-party dealing, when a transfer pricing benefit constitutes a differential between the taxpayers’ actual profits and those that should have accrued to it under arm’s length circumstances. This significantly broadens the ATO’s ability to consider taxpayers’ profitability and the overall commerciality of outcomes, as opposed to consideration on a purely transactional basis under Division 13.
- **OECD Materials relevant to interpretation** – Subdivision 815-A explicitly requires that it be interpreted consistently with OECD guidance, to the extent relevant. While this should help ensure that the ATO cannot depart from internationally accepted principles and approaches in applying the new transfer pricing provisions, some inconsistencies remain between the ATO and OECD approaches. For example, reconstruction is permissible only in exceptional cases under the OECD transfer pricing guidelines.
- **Interaction of transfer pricing/thin capitalization** – Subdivision 815-A includes a provision dealing with its interaction with Australia’s thin capitalization regime in Division 820 of the ITAA 1997, essentially adopting the ATO’s position in Taxation Ruling TR 2010/7.<sup>11</sup>
- **Penalties** – Penalties on a retrospective Subdivision 815-A adjustment are limited to what they would have been had subdivision 815-A never been enacted (that is, to the level of penalty imposable on a Division 13 or treaty article adjustment).
- **Allocating adjustments to particular expense/income line items** – The commissioner will be required to specify a particular income/expense item to which any determination (adjustment) relates, subject to the caveat “unless it is not possible or practicable to do so.”

Overall, Subdivision 815-A significantly strengthens the ATO’s position, in line with its existing views on issues such as its power to use profit methods to make transfer pricing adjustments, its power to require commercially realistic outcomes in the taxpayer’s circumstances, and its power to reconstruct transactions (such as pricing related-party debt by reference to arm’s length debt amounts).

## Phase 2 – Proposed Reforms “Hot Off the Press”

Having completed Phase 1 of the reform process in September 2012, Treasury maintained momentum by releasing exposure draft legislation<sup>12</sup> on 22 November 2012 on the Phase 2 reforms. The explanatory memorandum to the exposure draft legislation states<sup>13</sup> that:

“Australia’s transfer pricing rules seek to ensure that an appropriate return for the contribution made by Australian operations is taxable in Australia for the benefit of the community. The appropriate return is determined by application of the arm’s length principle, which aims to ensure that an entity’s tax position is consistent with that of an independent entity dealing wholly independently with others.”

The latest exposure draft legislation contains the following proposed subdivisions in ITAA 1997, with prospective effect:

- **815-13** – Arm’s length principle for cross-border conditions between entities
- **815-C** – Arm’s length principle for permanent establishments
- **815-D** – Recordkeeping requirements
- **815-E** – Special rules for trusts and partnerships

The main effect of the new rules is to replace Division 13 of the ITAA 1936. Indeed, Division 13 will be repealed once the new provisions are enacted, and the new law will apply prospectively. The existing Division 13 will continue to apply to income years prior to the enactment of Subdivision 815-B. Subdivision 815-A will also have no operation from the date of

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<sup>10</sup> Notably, however, the ATO has publicly announced that it will not retroactively apply Subdivision 815-A to reopen settled cases, including concluded audits, agreed advance pricing arrangements, and settled treaty Mutual Agreement Procedure (MAP) cases.

<sup>11</sup> The ATO is not free to apply its general profit adjustment powers under Subdivision 815-A to interest expenditure (and other debt deductions); rather, it is subject to the limits in Section 815-25 in making such adjustments.

<sup>12</sup> Tax Laws Amendment (Cross Border Transfer Pricing) Bill 2013 (Cth): Modernization of Transfer Pricing Rules.

<sup>13</sup> Explanatory Memorandum, Tax Laws Amendment (Cross Border Transfer Pricing) Bill 2013 (Cth): Modernization of Transfer Pricing Rules, paragraphs 1.5 and 1.6.

application of these changes (with the recent proposed reforms comprising catch-all provisions; i.e. whether or not taxpayers are operating in a tax treaty context). Importantly, the new rules explicitly state that the rules can also apply when there is no common control of related parties, if the dealings themselves are not at arm's length (for instance, through collusive practices between apparently independently owned entities).

The key changes based on the most recent proposed reforms are set out below.

**Definition of arm's length conditions** – The new rules allow for the substitution of arm's length conditions when an entity receives a transfer pricing benefit by virtue of non-arm's-length conditions between it and its international related parties. "Arm's length conditions" are defined as those that might be expected to exist between independent entities dealing wholly independently with one another in comparable circumstances.

**Economic substance requirement** – A taxpayer must be able to demonstrate that arrangements such as business restructurings and financing are substantially similar to what would have occurred between independent parties in comparable circumstances,<sup>14</sup> including demonstrating that the taxpayer was acting in its own best commercial interests. The commissioner will have regard to the underlying economic substance of what the parties have done (the legal form will not limit the commissioner's identification of arm's length conditions).

**Reconstruction powers** – Because of the ability to substitute arm's length conditions and look to the underlying economic substance of transactions, the new rules could potentially be used more extensively than the OECD transfer pricing guidelines on which they're based, given that the OECD transfer pricing guidelines allow for reconstruction of transactions in exceptional circumstances only. The initial reaction of taxpayers and professional bodies to the draft new rules suggests the issue causing the greatest cause for concern is the breadth of this proposed reconstruction power.

**Modification for thin capitalization** – Consistent with Subdivision 815-A, TR 2010/7 principles have been adopted in the exposure draft legislation. A taxpayer with related-party debt must be able to support the claim that the amount of that debt and the price (interest rate) of the debt are at arm's length for pricing purposes.

**Amendment of assessments** – An eight-year time limit on transfer pricing adjustments has been introduced. Currently, there is no time limit on transfer pricing adjustments.

**OECD interpretative materials** – The exposure draft directly incorporates the "most appropriate and reliable method" and comparability factors consistent with the OECD transfer pricing guidelines and the ATO's transfer pricing taxation rulings. Furthermore, Subdivisions 815-B and 815-C must be interpreted so as to best achieve consistency with the OECD transfer pricing guidelines and the OECD Model Tax Convention, respectively.

**Self-assessment** – Significantly, taxpayers will operate on a self-assessment basis. This means that a taxpayer must apply the arm's length principle to determine its taxable income before lodging its tax return, and public officers should ensure that they are satisfied that Australian entities' taxable income reflects arm's length conditions.

**Documentation** – A taxpayer should have all required documentation in place to support its transfer pricing filing position by the time it lodges its tax return. Failure to prepare and keep contemporaneous transfer pricing documentation will mean that the taxpayer is unable to argue that a reduced base penalty should apply on the basis that it has a reasonably arguable position (RAP).

**Penalties** – Administrative penalties will apply if a taxpayer is liable to pay additional income tax due to the commissioner's amending an assessment for an income year to give effect to subdivision 815-B or 815-C. Low *de minimis* concessions also apply (when the proposed transfer pricing adjustment amount falls below those thresholds, administrative penalties will not apply).

The new rules are most likely to have a significant impact on financing cases, business restructurings, and loss-making companies. However, all taxpayers are well advised to review their historic and forward-looking transfer pricing policies,

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<sup>14</sup> It is noted that in recent reforms to Australia's anti-avoidance rules in Part IVA ITAA 1936, the option of doing nothing is not a feasible counterfactual. However, under Subdivision 815-B, arguably when independent entities would not have entered into an arrangement and the economic substance of doing nothing is similar to what was actually done, an "arm's length outcome" may be to disregard the transaction on the basis that arm's length parties would not have entered into the transaction.

processes, documentation, filing positions, Schedule 25A and IDS disclosures, and risk mitigation strategies to ensure that they remain valid and robust in light of the proposed new rules.

As a next step on the Phase 2 reforms, Treasury called for submissions on the exposure draft by 20 December 2012. Once the consultation process is complete (and any revisions to the exposure draft have been made), a bill will be introduced into Parliament. Subject to passing both houses of Parliament and receiving royal assent, the new rules will have the force of law.

### **Phase 3 – Attribution of Profits to Permanent Establishments**

Phase 3 will involve the potential reform of Australia's permanent establishment profit attribution rules, in line with the Authorized OECD Approach (AOA). A discussion paper was released on 30 October 2012 in relation thereto.

In May 2012, the Australian government announced it had commissioned the Board of Taxation (BoT) to consider the implications of Australia's adopting the AOA in relation to profit attribution to PEs. Subdivision 815-C introduces rules on the attribution of arm's length profits to PEs. The rules cover both Australian PEs of foreign companies and overseas PEs of Australian companies. While the rules draw on concepts in Subdivisions 815A and 815-B (for example, transfer pricing benefit at risk, the operation of arm's length conditions), the PE rules currently follow the pre-2010 OECD Model Tax Convention Article 7 and commentary, which form the basis of the business profits article in Australia's treaties. The wording in subdivision 815-C aligns with the existing ATO approach – a separate and distinct entity approach and allocation of actual income and expenditure.

Subject to the outcome of the BoT review, it is possible that further changes to the PE rules may be made in 2013, given that the BoT is due to report its findings in April 2013.

### **The *GlaxoSmithKline* Case – Adding Fuel to the ATO's Fire?**

Many commentators, taxpayers, and practitioners have argued that Treasury (as legislative drafters) and the ATO (as administrators of the new rules) are flexing the arm's length principle to extend to a profitability level review. In light of recent global cases and other developments, it is reasonable to conclude that the Australian developments are progressive rather than aggressive in a transfer pricing context.

The Supreme Court of Canada recently issued its long-awaited decision in the *GlaxoSmithKline Inc* case. The Court decided that in determining arm's length pricing for the taxpayer's related-party purchases of a patented drug ingredient (ranitidine), it was necessary to take into account its licensing agreement for manufacturing and selling the associated branded product (Zantac). The Court found, in effect, that the (substantially lower) prices paid between independent parties for ranitidine for making and selling equivalent generic (unbranded) products were not comparable uncontrolled prices for the taxpayer's ranitidine purchases, as the Canada Revenue Agency had argued.

In so doing, the Court referred to the OECD transfer pricing guidelines, which state that in making comparisons to apply the arm's length principle, it is necessary to have regard to the "economically relevant characteristics" of the situations being compared. Significantly, the SCC found that the taxpayer derived a price premium from selling Zantac compared to the equivalent generic product, and that considering its supply and license agreements together (that is, considering the totality of its arrangements) offered a "realistic picture" of its profits.

The Court's reliance on the OECD transfer pricing guidelines, and consideration of the taxpayer's transactions and outcomes in their totality, is of interest and relevant to Australian taxpayers. In *SNF*, the Full Federal Court decided that, in interpreting and applying Division 13, it was not relevant to consider all of the taxpayer's circumstances (such as its financial characteristics and the fact that it was continuously incurring losses), as the ATO had argued. That court refused to allow the ATO to use the OECD transfer pricing guidelines in interpreting Division 13. On this basis, the ATO should welcome the Canadian *GlaxoSmithKline* decision, to the extent that it highlights the need to consider transfer pricing more broadly than simply looking at individual transactions in isolation, even when a transactional method, such as the CUP method, is being used. The Canadian decision can only encourage the ATO in its ongoing targeting of loss makers, such as in the *SNF* scenario, and more generally in continuing to argue the need to consider whether the profit allocation outcomes of a taxpayer's related party arrangements are "commercially realistic."

## The ATO's Risk-Profiling Measures

The ATO embarked on a Strategic Compliance Initiative (SCI) in 2009/10, seeking to identify taxpayers for audits and risk reviews based largely on disclosures made in their Schedule 25A<sup>15</sup> filings as part of the income tax returns. The SCI yielded mixed results, demonstrating that the ATO required more targeted risk-profiling measures to accurately assess potential lost revenue to the Australian treasury.

This result led to the introduction of a pilot International Dealings Schedule (IDS). The IDS, first tested on taxpayers in the financial services industry, must now be completed by all taxpayers from the 2012 income year, for taxpayers lodging after 1 July 2012.

Part A of the IDS, replacing Schedule 25A, is far more detailed than its predecessor, and is aimed at extracting key related-party information from taxpayers to enable the ATO to identify and better understand potential risk areas. It requires granular disclosures in terms of the nature and type of transaction entered into and, importantly, the documentation on hand to support the pricing of each transaction. The IDS requires disclosure of cross-border dealings with related parties in "specified countries," such as the Cayman Islands, Bermuda, and the Isle of Man, and contains specific questions on business restructurings, employee share schemes, cost contribution arrangements, and branch operations. Key focus areas for the ATO, based on taxpayers' IDS disclosures, include:

- Loans
- Business restructurings
- Royalties
- Services (broadly defined to include guarantees, treasury, insurance, etc.)
- Intangible property
- Employee share schemes
- Derivative transactions
- Debt factoring and securitization arrangements
- Provision of services/IP for nil or limited consideration.

The IDS, therefore, plays a critical role in the ATO's risk assessment process, and is effectively a roadmap for the ATO to select taxpayers for risk reviews and further investigation.

The ATO has also developed a Reportable Tax Position Schedule (RTPS) to the corporate tax return that focuses on the collection of information about large business taxpayers' most contentious material tax positions. This new schedule is part of an information disclosure package designed to provide assurance and help the ATO better understand tax risk for the large business community. In a self-assessment environment, the onus on taxpayers to identify and report any uncertain material tax positions is heightened. Through schedules such as the IDS and RTPS, the ATO will have a far clearer picture of taxpayers' risk areas. Preparing documentation that provides a RAP will arguably alleviate the need to make disclosures on the RTPS.

Given the above, regard must be had to practical considerations for multinationals with existing Australian operations/cross-border related-party transactions, as well as those seeking to establish an Australian presence.

## Transfer Pricing Documentation Requirements

The ATO currently expects taxpayers to prepare documentation that complies with a suggested "four-step process" for documenting and reviewing transfer pricing arrangements.<sup>16</sup> The documentation disclosures on the IDS refer specifically to documentation on hand being in this format. The four-step process can be summarized as follows:

- **Step 1** – Accurately characterize the international dealings between associated enterprises in the context of the taxpayer's business.

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<sup>15</sup> Schedule 25A was the four-page form accompanying the company income tax return (predecessor to the IDS), where taxpayers were required to disclose the nature and quantum of their cross-border related-party dealings (including, nonexhaustively, sales, services, royalties, and loans).

<sup>16</sup> TR 98/11 paragraph 5.2.

- **Step 2** – Select the most appropriate transfer pricing method or methods.
- **Step 3** – Apply the most appropriate method(s) and determine the arm’s length outcome(s).
- **Step 4** – Ensure documentation is complete and implement support processes. Install a review process to ensure adjustment for material changes.

As previously noted, the most recent exposure draft (in particular Subdivision 815-D ITAA 1997) contains record maintenance requirements. The proposed amendments provide that an entity that does not have the documentation required by Subdivision 815D is treated as not having a RAP about the application of the transfer pricing provisions in Subdivisions 815-B or 815-C. However, it is also stated that documentation that meets the requirements in Subdivision 815-D is necessary, but not sufficient, to establish a RAP. It remains unclear why a taxpayer might be considered not to have a RAP if it has transfer pricing documentation in place. Arguably, a taxpayer who has documented in accordance with Subdivision 815-D should be treated as having a RAP about the application of the transfer pricing provisions.

Under existing guidance, a taxpayer who has documented in accordance with the four-step process in TR 98/11 will have penalties remitted in full. Therefore, it does not make sense from a policy perspective that a taxpayer who has documented in accordance with Subdivision 815-D may be treated as not having a RAP, and thus be subject to a base penalty of at least 25 percent.

These issues are expected to be addressed in future iterations of the exposure draft and explanatory memorandum, given the need to address how and to what extent the documentation required under Subdivision 815D aligns with the ATO’s four-step process and the OECD’s nine-step process.<sup>17</sup> Not only would this clarify the requirements under Subdivision 815-D and provide certainty to taxpayers, it might reduce their compliance burden to the extent that existing processes performed and documentation prepared for purposes of Australia’s current transfer pricing laws remain appropriate.

## Practical Considerations

In light of the significant changes to Australia’s transfer pricing provisions and taxpayers’ reporting requirements, some potential risk management strategies that MNCs would be prudent to consider in Australia include:

- Reviewing the commerciality of outcomes (are sufficient profits being reported by Australian entities based on their functions, assets, and risks? Are losses attributed to non-transfer-pricing-related issues?)
- Bolstering defensive transfer pricing documentation and documenting previously undocumented transactions and filing positions.
- Revisiting transactional pricing (for example, if the CUP method has been used to price sales of goods or services to related parties, look more broadly to the profits in the supply chain to ensure no transfer pricing benefit exists that the ATO could argue should be brought to account in Australia).
- In a financing context, monitoring the thin capitalization ratio of Australian entities and ensuring interest rates are supported by comprehensive debt pricing analyses, with specific reference and regard to the borrower’s credit rating and key terms of the financing agreements.
- For taxpayers contemplating business restructures, ensuring that the commercial reasons for their reorganizations are robust and well documented, as well as supporting the arm’s length nature of intragroup pricing following a restructuring.
- For taxpayers with “at-risk” transfer pricing positions, applying for and negotiating advance pricing agreements (APAs) to achieve certainty and avoid potentially costly ATO disputes.

For taxpayers seeking to achieve a greater level of certainty with regard to transfer pricing, APAs may be an attractive avenue to pursue. The ATO issued Practice Statement PSLA 2011/1 on APAs in 2011 after undertaking a project to revamp its APA procedures, which involved identifying best practice recommendations for both the ATO and taxpayers. This reinvigorated taxpayers’ interest in entering into APAs (whether unilateral or bilateral) to achieve certainty on their transfer pricing matters.

While APAs may be more time-intensive and costly than preparing documentation in house, APAs provide a far greater level of certainty because they involve revenue authority “buy-in” with regard to transfer pricing mechanisms. Despite the risk of unfavorable outcomes (the ATO could seek information on noncovered transactions and “collateral” tax issues) and though

<sup>17</sup> Per paragraph 3.4 of the OECD transfer pricing guidelines.

APAs cannot guarantee prevention of “active compliance” (a risk review or audit) by the ATO, APAs significantly reduce taxpayers’ level of risk. Furthermore, the annual compliance reporting requirements associated with APAs are not particularly onerous.

## Conclusion

The increasing impact of globalization means that the Australian government sees the transfer pricing rules as critical to the integrity of its tax system. On this basis, the Australian Treasury and the ATO have been particularly active in the transfer pricing space in recent times, with this activity culminating in the revision of Australia’s domestic transfer pricing provisions and the undertaking of other, transfer pricing-related initiatives. Treasury’s newly initiated review of the taxation of MNCs in Australia also has the potential to significantly change the landscape of taxation in the country.

To address their Australian transfer pricing obligations and risks appropriately, MNCs should continue to follow changes to the Australian and global transfer pricing landscapes. Taxpayers potentially affected by changes in the retrospectivity aspect of Subdivision 815-A and who are at risk of an audit in respect of the 2004-2012 years should consider the implications of the changes to the transfer pricing provisions for their operations.

Now more than ever, it is essential that MNCs ensure that their transfer pricing policies, filing positions, disclosures, documentation, and risk mitigation strategies remain appropriate in light of transfer pricing rules that continue to evolve apace.

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## Greece Modernizes Transfer Pricing Regime

The Greek Parliament has approved a tax bill that makes significant and far-reaching changes to the country’s tax rules, including the transfer pricing regime.

The new law – Law 4110/2013 – rationalizes and modernizes Greece’s transfer pricing rules, and consolidates the legislative framework for transfer pricing documentation. Among the changes are a broadening of the definition of related entities and the scope of the rules, and the introduction of an advance pricing agreement procedure.

### Background

The Greek Income Tax Code has incorporated the arm’s length principle with respect to intercompany transactions since 1980. Specifically, article 39 of the Greek Income Tax Code stipulates that when the price paid to (or received by) related enterprises for goods sold or services rendered differs unjustifiably from the price that would be agreed upon by unrelated parties under open market conditions, the difference is added to the taxable profits of the company that either paid the higher or received the lower price. If the authorities concluded upon audit that a non-arm’s-length transfer pricing policy existed, that determination would trigger a separate fine of 10 percent of the amount of the price difference, as well as additional corporate tax and surcharges for filing inaccurate corporate tax returns. However, the tax authorities did not provide any analytical guidance on how the arm’s length principle could be tested in practice. Tax auditors were not sophisticated and tried to apply the comparable uncontrolled profits (CUP) method wherever possible.

The above framework changed in 2008, when transfer pricing documentation rules were adopted, first by the Ministry of Development (with Law 3728/2008), as a means to pressure consumer goods companies not to increase the market prices of their goods. At a second stage, the Ministry of Finance issued its own legislation (Law 3775/2009) on transfer pricing documentation rules by amending the then existing provisions of the Income Tax Code.

The existence of two parallel and different sets of legislation for transfer pricing documentation issues has created confusion and increased compliance efforts for taxpayers. For four years, the main topic discussed in any relevant forum was how to unify and rationalize the legislative framework.

## Compliance with Arm's Length Principle

The new law broadens the definition of the term "related entities." Moreover, the obligation to comply with the arm's length principle is no longer limited to transactions for the sale of goods or the provision of services, but is extended to all types of intragroup transactions, such as loans and transfers of shares and real estate.

The following transactions now specifically fall within the scope of the transfer pricing rules:

- Loans granted to related entities;
- Transfers of real estate between related entities;
- Transfers of shares, parts, and business sectors between related entities; and
- Transactions with related entities based in "non-cooperative" jurisdictions or in "favorable tax regimes."

Provisions regarding the computation of a deemed minimum value or capital gain no longer apply to intercompany transactions.

No separate penalty is provided in case a transfer pricing adjustment is assessed by the tax audit. In such a case, the price difference is added to the taxable profits of the audited company, triggering the application of the standard corporate tax rate along with penalties for inaccurate filing of the corporate income tax return.

## Documentation Requirements

L.3728/2008 of the Ministry of Development was abolished, with the obligation to document the pricing of intragroup transactions now deriving only from the Income Tax Code. The list of intragroup transactions previously required by the Ministry of Development is now replaced by a summary information table, which must be submitted electronically to the tax authorities no later than 50 days after the end of each financial year. For fiscal year 2012, the summary information table must be submitted by 10 May 2013.

Companies operating in Greece must prepare a Transfer Pricing Documentation File for transactions with domestic and foreign affiliated entities. The file must be prepared before publication of the Tax Compliance Report (Tax Certificate) and, in any case, no later than 50 days after the end of a fiscal year. For financial year 2012, the deadline for compilation of the documentation file and submission of the summary information table is 10 May 2013. The documentation file must be made available to the tax authorities within 30 days following a request.

Transactions with related entities that do not exceed EUR 100,000 in total are exempt from the documentation requirement, provided the operating revenue of all related parties does not exceed EUR 5 million. The threshold is EUR 200,000 for groups whose annual turnover exceeds EUR 5 million.

A ministerial decision will be issued to provide details on the content of the transfer pricing documentation file and the summary information table.

Late filing of the documentation file or the summary information table will give rise to a one-time penalty calculated at 0.1 percent of the company's revenue. However, the penalty cannot be less than EUR 1,000 or more than EUR 10,000. If the taxpayer fails to submit either document, the one-time penalty will be calculated at 1 percent of the company's revenue, but not less than EUR 10,000 or more than EUR 100,000.

These provisions are effective retroactively for transactions that take place in accounting periods that commence from 1 January 2012. Transfer pricing documentation of transactions that took place in financial years 2010 and 2011 will be governed by the provisions of L. 3728/2008.

## Advance Pricing Agreements

The new law introduces an APA program from 1 January 2014, which will enable taxpayers to obtain advance approval of their transfer pricing practices. APAs will be available for all the criteria used to determine transfer prices (transfer pricing method, comparable data, adjustments, and key assumptions, for example), but will not cover a nominal price or margin.

The term of an APA may not exceed two years, although it will be possible to renew the APA twice, provided there are no significant changes in the facts on which the initial approval was based. When an APA is granted, a tax audit is limited to verifying that the terms of the APA have been respected, and that the key assumptions used in the APA are still in effect.

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## **Brazil Amends Transfer Pricing Rules on Financial Transactions**

The Brazilian government on December 28, 2012, published new transfer pricing rules on financial transactions. Law 12,766/2012 amends Law 12,715, approved approximately 90 days before, which introduced new transfer pricing rules on intercompany loan transactions by expanding the scope of the rules to include all financial transactions involving interest payments. In practice, the provisions related to interest included in Law 12,715 did not have any effect, because they were scheduled to enter into effect on January 1, 2013. New Law 12,766 supersedes those provisions.

The Brazilian revenue services on December 31 published Normative Ruling 1,312 to regulate the application of the new transfer pricing rules enacted by Law 12,715. However, the language in the ruling is not consistent with Law 12,766. The Brazilian revenue services will likely issue an additional ruling addressing the new transfer pricing rules on financial transactions soon.

The new transfer pricing provisions on financial transactions are applicable to new contracts starting on or after January 1, 2013. The new rules grandfather financial transactions entered into before January 1, 2013, as long as they are not renegotiated or amended in tax periods after the new transfer pricing provisions become effective.

### **Historical Treatment of Intercompany Financial Transactions**

When the Brazilian transfer pricing rules were originally enacted through Law 9,430/1996, they specifically indicated that financial transactions registered with the Brazilian Central Bank (BACEN) were outside the scope of the new rules. Otherwise, the reasonableness of interest expense or revenue associated with the transactions had to be consistent with the six-month London Interbank Offered Rate (Libor) for U.S. dollar deposits, increased by an annual spread of 3 percent on a pro rata basis. In practice, despite some debate regarding the concept of “registered” transactions, virtually all inbound contracts were registered with BACEN after the introduction of the web-based system RDE-ROF in 2001.

Back in 1996, BACEN’s technicians would review, approve, or reject all contracts involving inbound and outbound financial transactions. It was a bureaucratic process whereby taxpayers had to submit the proposed contract to BACEN and await a response. At that time, it made sense to allow financial transactions registered with BACEN to remain outside the scope of the transfer pricing rules, under the rationale that if BACEN approved a given transaction, the interest expense or revenue associated therewith must be adequate, and analyzing those from a transfer pricing perspective would erode BACEN’s authority.

In 2001, BACEN established an electronic process for taxpayers to report their financial transactions. Although draft contracts were no longer reviewed by a technician, BACEN could still challenge the transactions if they were considered inadequate.

Taxpayers have long argued that the process of informing BACEN of their intercompany financial transactions was sufficient to allow those transactions to fall outside the scope of the transfer pricing rules. Until recently, the Brazilian tax authorities seemed comfortable with that assumption, and taxpayers were rarely challenged on the matter.

Law 12,715/2012, published in September 2012, made significant changes to the Brazilian transfer pricing rules. The new transfer pricing rules specifically provided that interest associated with intercompany loan transactions would not be deductible if it was not consistent with the six-month LIBOR plus 3 percent annual spread, *regardless of registration with BACEN*. This change would introduce a flat criterion applicable to all old and new contracts.

It is important to point out that Law 9,430/1996 dealt with *financial transactions* not registered with BACEN, whereas Law 12,715/2012 deals with *intercompany loan transactions*. Based on the language of Law 12,715/2012, taxpayers and tax practitioners wondered whether any other interest-bearing financial transactions would fall outside the transfer pricing spectrum as long as they were registered with BACEN. The new Law 12,766 represents a quick fix to address the uncertainty associated with Law 12,715 from September 2012, even before the older law became effective.

## Highlights of New Rules

The basic rule is that the “limit” (maximum for inflows and minimum for outflows) is a combination of a “rate” plus a “margin” (spread). Different rates are provided, depending on the type of transaction, the currency used, and other factors. The margin will be determined by the minister of finance, but it is unclear at this point if there will be different spreads for each type of transaction or just one fixed margin as in the past (when a flat spread of 3 percent provided a safe harbor). Also, it is not clear when and how often this spread will be published, a fact that brings some uncertainty to the analysis. The only information provided is that the spread will be a “market average,” without clarification as to which market and what type of average will be adopted.

The rates are defined as follows:

Currency	Market	Type	Rate Limit
USD	Foreign	Fixed rate, predetermined	Market rate of sovereign bonds of Federative Republic of Brazil, issued in USD, in foreign markets
Real	Foreign	Fixed rate, predetermined	Market rate of sovereign bonds of Federative Republic of Brazil, issued in Reais, in foreign markets
Any(a)	Any(a)	Any(a)	Libor for six months for the respective currency adopted (b)
Real	Foreign	Variable	May be determined by the Minister of Finance
<p>a) The LIBOR limit considers the adoption of any currency, market, and type resulting in different combinations other than those specified for other rate limits.</p> <p>b) If there is no specific LIBOR for the currency adopted, six-month LIBOR in U.S. dollars should be used.</p>			

A very important factor introduced by Law 12,766 is the concept of the “verification moment,” that is, the point in time when a taxpayer should test the transaction for transfer pricing purposes. New paragraph 9 of article 22 establishes that this verification should be done “on the contract date of the transaction” and not on a periodical way, as previously stated by Law 12,715.

## Conclusion

Law 12,766 introduces significant changes to the Brazilian transfer pricing rules on financial transactions, which had previously not been well regulated. The new rules represent a significant advance to align the Brazilian transfer pricing rules on these transactions with the international standards by avoiding the adoption of fixed flat rates. Taxpayers should consider carefully the appropriate limit at the time of the contract date and avoid closing contracts until further clarification regarding the spread/margin and official source of information for the rates to be used.

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## Serbia Amends Transfer Pricing Legislation

The evident problems arising from Serbia's transfer pricing legislation made its reform a priority for the government that took office in mid-2012. A new law, approved by the Serbian Parliament on Dec. 15, 2012, and in force as of Jan. 1, 2013, is an effort to address transfer pricing in a comprehensive manner and resolve issues that arose in the past.

### Changes Regarding Related-Party Status

The new law<sup>18</sup> lowers the required participation in the shares or votes in the governing bodies of a taxpayer for related-party status from the previous 50 percent or more to at least 25 percent. The criterion whereby possession of the single largest portion of shares or votes in the governing body of a taxpayer rendered that entity a related party, regardless of the size of the participation, has been abolished.

Related-party status with a Serbian taxpayer and the corresponding transfer pricing (and thin capitalization) implications for transactions entered into with them apply to all legal entities from jurisdictions with preferential tax regimes.

Any nonresident legal entity that is established, has a registered seat, management seat, or place of effective management in a jurisdiction with a preferential tax regime and which cannot be deemed a resident of a country with which Serbia has entered into a double tax agreement<sup>19</sup> is *per legem* considered a related party of any Serbian taxpayer, regardless of the existence of any particular indication of a specific relationship.

At the moment, the list of jurisdictions Serbia deems to have preferential tax regimes includes 51 countries and territories.<sup>20</sup>

### New Transfer Pricing Methods and Introduction of "Best Method" Approach

The application of transfer pricing methods was a notable issue in the past, which the new law attempts to solve in two ways. First, instead of granting primacy to the comparable uncontrolled price (CUP) method, the "best method" approach is applied, under which all transfer pricing methods are given equal preference and the taxpayer's choice depends on the circumstances of a particular case. In addition to the already approved CUP, cost plus, and resale minus methods, the transactional net margin method and the profit split method have been added. The new law allows the combination of several methods for transfer pricing purposes, and the use of any alternative method, provided the use of the enumerated ones is not possible, or the alternative method better meets the requirements under the circumstances at hand.

With respect to the application of transfer pricing provisions to loans between related parties, the new law provides an option for the Minister of Finance to grant taxpayers a safe harbor in the form of interest rates that will be deemed to be at arm's length. The law entitles taxpayers to use general arm's length principles instead of the safe harbor interest rates, on condition that the same approach is applied to all loans to or from related parties. If a taxpayer chooses not to apply the safe harbor interest rates, the Serbian Tax Administration is not bound to follow them either.

### Disclosing Related-Party Transactions and Transfer Pricing Effects

Under the previous system, taxpayers were required to disclose their total revenues and expenses from related-party transactions at controlled and at arm's length prices, and an adjustment of the tax base could arise if even after a set-off of

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<sup>18</sup> *Official Gazette of the Republic of Serbia*, no. 119/12.

<sup>19</sup> Serbia has entered into double taxation agreements with the following 49 countries: Albania, Austria, Azerbaijan, Belgium, Byelorussia, Bosnia and Herzegovina, Bulgaria, China, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, India, Italy, Iran, Ireland, Kuwait, Latvia, Libya, Lithuania, (FYR) Macedonia, Malaysia, Malta, Moldova, Montenegro, the Netherlands, North Korea, Norway, Pakistan, Poland, Qatar, Romania, Russian Federation, Slovakia, Slovenia, Spain, Sri Lanka, Sweden, Switzerland, Turkey, Ukraine, and the UK.

<sup>20</sup> Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Christmas Island, Cook Islands, Dominican Republic, Falkland Islands, Fiji, Gibraltar, Grenada, Guam, Guernsey, Guyana, Hong Kong, Isle of Man, Jersey, Liberia, Liechtenstein, Macao, Maldives, Marshall Islands, Mauritius, Monaco, Monserrat, Nauru, Netherlands Antilles, Niue, Normand Isles, Palau, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa, San Marino, Seychelles, Solomon Islands, Tonga, Trinidad and Tobago, Turks and Caicos Islands, Tuvalu, US Virgin Islands, Vanuatu. Rulebook on list of jurisdictions with a preferential tax regime, *Official Gazette of the Republic of Serbia*, no. 122/12.

all transactions (on the expense and on the revenue side, respectively) total controlled expenses were above or revenues were below the arm's length amount. Under the new law, taxpayers are obligated to declare only the total amount of expenses and revenues from related parties at controlled prices.

New rules expressly introduce an obligation for taxpayers to prepare per-transaction transfer pricing documentation. The precise contents of the required documentation will be regulated by the Serbian Ministry of Finance.

The new law solves the crucial dilemma of arm's length ranges, on which the previous legislation was silent (except for the CUP method). Under the new rules, if the controlled price is within the arm's length range, then no adjustment is warranted; in cases in which an adjustment is required, the medium value of the range is to be used. The use of the term *medium value* was intended to enable the Serbian Ministry of Finance to specify in the forthcoming by-laws the use of both the weighted average and the statistical median approach when appropriate, and not be legally bound to just one.

The new legislation expressly allows the application, for transfer pricing purposes, of both the combined and the separate transaction approach. The new law empowers the Minister of Finance to allow set-offs, if he so chooses, provided they relate to transactions with a specific related party and that they do not lead to the lowering of the tax base below the amount established under the controlled prices.

Finally, the new law limits corresponding adjustments only to situations in which the provisions of double taxation agreements apply. In other words, for domestic transactions, no corresponding adjustments are possible, while in the case of cross-border transactions, a request for a corresponding adjustment must be based on the relevant provision of an applicable double taxation agreement. Such a solution represents a significant improvement over the previous state of affairs, when corresponding adjustments based on double taxation agreements were completely unknown and unregulated.

## OECD Transfer Pricing Guidelines

Serbian lawmakers decided to expressly bind the Serbian Ministry of Finance primarily to the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, but also refer to work done regarding related-party transactions by other international organizations, such as the United Nations. The Minister of Finance is instructed to *rely* on these sources when enacting the by-laws (expected to be issued in 2013) that are necessary for the implementation of the new transfer pricing provisions.

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**Have a question?**

If you have needs specifically related to this newsletter's content, send us an email at [clientsandmarketsdeloittetax@deloitte.com](mailto:clientsandmarketsdeloittetax@deloitte.com) to have a Deloitte Tax professional contact you.

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