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Global Transfer Pricing

Arm's Length Standard

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In this issue:

US Tax Court Invalidates Cost Sharing Rule in *Altera* Decision

The US Tax Court on July 27 struck down the requirement in the 2003 cost sharing regulations that participants in a qualified cost sharing arrangement share stock-based compensation costs. The court granted petitioner Altera Corporation's motion for partial summary judgment and held that the regulation is invalid, because the US Treasury failed to support its belief that unrelated parties would share stock-based costs with any evidence.

At issue in the *Altera* decision – a reviewed decision in which 14 judges agreed with Judge L. Paige Marvel's opinion, and only two did not participate in the case – was the IRS's assessed tax deficiency for tax years 2004-2007.

The Tax Court had already invalidated a previous version of the regulations that did not explicitly require controlled parties entering into qualified cost sharing agreements to share stock-based costs, and the Ninth Circuit had affirmed that decision. *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), aff'd, 598 F. 3d 1191 (9th Cir. 2010). In 2003, Treasury issued 1.482-7(d)(2), which requires participants in qualified cost sharing arrangements to share stock-based compensations costs to achieve an arm's length result. Thus, 1.482-7(d)(2) was in effect during the years at issue.

Judge Marvel wrote that the preamble to the regulation offered only Treasury's belief that unrelated parties entering into qualified cost sharing agreements would generally share stock-based compensation costs, but that Treasury failed to engage in any fact finding, and failed to examine the relevant data that had been provided by numerous commentators that parties operating at arm's length would not share stock-based compensation.

In finding that the regulation is invalid, the court concluded that "the final rule lacks a basis in fact, Treasury failed to rationally connect the choice it made with the facts found, Treasury failed to respond to significant comments when it issued the final rule, and Treasury's conclusion that the final rule is consistent with the arm's length standard is contrary to all of the evidence before it."

Deloitte Tax LLP's transfer pricing practice is drafting an in-depth analysis of the case and its repercussions for the next issue of *Arm's Length Standard*.

OECD Provides Update on Transfer Pricing Issues at July Public Consultation

The Secretariat of the Organization for Economic Cooperation and Development (OECD) provided on July 7 an update on the status of various transfer pricing matters in connection with Actions 8, 9, and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan. The three-hour meeting, held at the OECD Conference Center in Paris, included a presentation by Andrew Hickman, head of the OECD's Transfer Pricing Unit, and Marlies de Ruiter, head of the Treaty and Transfer Pricing division, followed by a Q&A session. Although no final decisions have been made, the session highlighted areas in which progress has been made and those in which additional work will be needed to reach consensus.

The most anticipated and longest segment of the presentation was in connection with the status of the revisions to Chapter I of the OECD's transfer pricing guidelines following the December 19, 2014, release of the non-consensus discussion draft on risk, recharacterization, and special measures (the discussion draft), and the public consultation held March 19, 2015. That public consultation followed the submission by interested parties of over 1,000 pages of comments on the discussion draft.

The OECD did not release revised drafts; the materials provided for the presentations consisted of only a few slides.

Based on the presentation by the Secretariat and comments made by member country representatives, Working Party 6 appears to have reached consensus on some issues:

- **No Special Measures:** The lack of a need for so-called "special measures" (which would provide guidance departing from the arm's length standard, and would be applicable only in certain specific circumstances). Hickman, and at least one member country delegate, indicated that WP6 concluded there would be no need for departure from the arm's length standard in the guidance provided in the post-BEPS transfer pricing guidelines (including in the guidance on hard-to-value intangibles, or when dealing with cash boxes). This development, if found to be true, may be seen as a significant accomplishment for businesses and the US delegates to WP6.

- **“Control Over Risk” Threshold Test:** For tax administrations to uphold the contractual allocation of risk to an affiliated enterprise within a multinationals enterprise (MNE), the affiliated enterprise allocated the risks must exercise “control over risks.”
- **“Financial Capability” Threshold Test:** For tax administrations to uphold the contractual allocation of risk to an affiliated enterprise within an MNE, the affiliated enterprise allocated the risks must be capable of bearing the financial downside of the risks. However, it is unclear how financial capacity will be determined.
- **No Special Measures for Cash-Boxes but Debt Return:** Cash boxes (low-functionality entities that are highly capitalized) will be entitled to a risk-free rate of return unless they can exercise control over risk.
- **Moral Hazard Concept Eliminated:** The elimination of the notion of “moral hazard,” which was first introduced in the discussion draft and was heavily criticized in written comments submitted by businesses and other interested parties, appears to be agreed upon.
- **Risk Management Outsourcing Permitted:** Allowing the subcontracting of day-to-day risk management functions (for arm’s length consideration) as long as the subcontractor exercises “control over the risks” (within the meaning Chapter I will assign to the term).
- **Contracts Are the Starting Point:** Reversing the guidance provided in the discussion draft, the OECD appears to have reached consensus that contracts should be given significant weight and are the starting point for the accurate delineation of transactions (see below).
- **Transactions Must Be Accurately Delineated:** Requiring an accurate delineation of the controlled transaction, starting with an analysis of the contractual terms, and complemented with an analysis of the behavior of the parties and with a specific identification and analysis limited to *material* risks. WP6 has agreed that the risk analysis is on an equal footing with (rather than elevated above) the other two key elements of a functional analysis – functions performed and assets used.
- **Ex-Post Results Can Differ From Ex-Ante Expectations:** The notion that it is acceptable for *ex-post* financial results to deviate from *ex-ante* expected results. However, there still appears to be quite a bit of disagreement between member countries as to how much differences between *ex-ante* expectations and *ex-post* results tax administrations will accept before adjusting either, based on (i) resolution of informational asymmetries (as provided in the HTVI guidance of Chapter VI); or (ii) a recharacterization of the party entitled to unanticipated downsides and upsides based on control over risk or financial capability to bear risks.
- **Recognition Guidance Back to 2010 Version:** Guidance will be provided on the *recognition* of an accurately delineated transaction (as is currently the case in the 2010 version of the transfer pricing guidelines under D.2 Recognition of the Actual Transactions Undertaken) rather than on the *non-recognition* of an accurately delineated transaction. Hickman indicated that WP6 went back to the “commercially rational manner” language of D.2.1.65 of the 2010 transfer pricing guidelines to determine whether a transaction should be recognized, and new examples are provided.
- **Financial Services Transactions:** Specific and separate guidance will be provided for financial services transactions.

The “financial ability” threshold requirement, along with the “control over risk” threshold requirement for a risk allocation to be respected by tax administrations is likely to affect a large number of MNEs that have low-risk contractual arrangements within the MNE. Specifically, if "control over risk" is deemed by tax administrations to be exercised by a low-risk service provider that is not financially capable (within the meaning Chapter I will assign to the term) rather than by a financially capable entrepreneur deemed to not exercise control, it is unclear to which entity within the MNE the guidance would allocate the difference between the expected return and the actual return.

When specifically asked about that important issue, de Ruiter indicated that the OECD probably will not address it in its final guidance, leaving the answer up to the specific tax administrations to determine. Failure to provide guidance on this specific point will likely create a level of uncertainty taxpayers may not be comfortable with.

Based on the Secretariat's presentation and comments by member country representatives, WP6 does not appear to have reached consensus on the following issues:

- **Appropriate Threshold of "Control Over Risks":** Both the exact definition of "control" and the level of control that will be required appear to be undecided. This is a critical issue, because it is one of the key tools tax administrations can use to reallocate risk from the party contractually allocated the risk. However, there appears to be greater recognition that comparable companies used in benchmarking analyses perform risk functions.
- **Tolerance for Ex-Post Results to Vary from Ex-Ante Expectations:** Although conceptually there seems to be agreement among WP6 members that such differences are normal and not *per se* indicative of BEPS, in practice such differences still appear to raise a strong suspicion among some member countries that it is indicative of BEPS. The HTVI guidance will likely provide a threshold test applicable to HTVI (but not necessarily applicable outside of HTVI). As stated above, it remains unclear whether guidance on this issue will be provided in situations not covered by the HTVI rules.

These areas of contention are foundational, are linked, and have implications that extend beyond Chapter I of the transfer pricing guidelines. For example, the HTVI section of Chapter VI is directly affected by the *ex-post* versus *ex-ante* issue above, and the cost contribution arrangement guidance provided under Chapter VIII is directly affected by both issues above.

Although Michelle Levac, co-chair of WP6, and Hickman both made a point that the information provided by the Secretariat reflects only WP6's current thinking, and is not necessarily indicative of where WP6 will end up, encouraging progress appears to have been made since the public consultation of March 19. This cautious optimism should be tempered, as no actual language reflecting the points of consensus currently achieved can yet be examined; the devil in transfer pricing often hides in the details.

As discussed herein, WP6 faces significant remaining challenges, particularly timing, which is placing a lot of pressure on member country delegates and the Secretariat to resolve the remaining critical areas of differences. The OECD must finalize its revised transfer pricing guidelines by the last week of July 2015 to allow sufficient time for polishing, translating, and publishing the various papers (August 2015) for submission first to the OECD Committee on Fiscal Affairs ("CFA") for formal approval (September 2015), and then finally to the G20

Finance Ministers Meeting on October 8 for ratification. The final revised changes are expected to be released a few days prior to the G20 Finance Ministers' meeting.

Other updates provided by the Secretariat on July 7 include:

- WP6 has reached consensus on the commodity transaction guidance provided under Chapter II of the transfer pricing guidelines. The consensus draft has been submitted to the CFA for formal approval.
- All Action 13 deliverables, including the documentation requirements under Chapter V and country-by-country reporting will be combined into one report.
- Additional agreements have been reached on Dispute Resolution (Action 14) along two building blocks of (i) mandatory minimum standards and an associated monitoring process, and (ii) a voluntary commitment to mandatory and binding arbitration. Twenty countries have agreed to include binding arbitration in their income tax treaties.
- WP6 has decided that the special rules applicable to low-value services will not apply if the allocation to a particular country is "large." This provision was included to protect developing countries that were concerned they would be required to accept large service allocations without documentation of the benefits received.
- Guidance on financial transactions (Chapters I and VII), on profit splits (Chapter II), and on profit attribution to permanent establishments (Action 7) will not be part of the final deliverables to the G20 on October 8. The profit splits guidance is expected to be developed in 2016 and 2017; the profit attribution guidance is expected in 2016, and the timetable for guidance on financial transactions is unclear.
- WP6 will release additional implementation guidance on HTVI in 2016.
- The OECD has been tasked by various international organizations to develop a toolkit to assist developing countries in their implementation of BEPS.

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Australian Taxation Office Issues Guidance on APAs

The Australian Taxation Office (ATO) recently released Practice Statement Law Administration PS LA 2015/4, a guide for advance pricing arrangement (APA) negotiations. PS LA 2015/4 replaces the ATO's previous practice statement on APAs – PS LA 2011/1 – effective July 23, 2015, although in some regards PS LA 2014/5 merely confirms changes to the ATO's APA process that have been applied in practice to actual cases over the past year.
URL: http://law.ato.gov.au/atolaw/view.htm?docid=%22PSR%2FPS20154%2FNAT%2FATO%2F00001%22

The ATO's APA program has been updated to ensure it reflects changes in the global economy, the community, and the ATO's broader anti-profit-shifting work. PS LA 2015/4 reflects the ATO's intensified level of stewardship of the APA program and its desire to ensure a consistently high-quality level of service.

Set out below are the key components of PS LA 2015/4, together with practical guidance on what taxpayers can expect under the ATO's new APA program.

Stages of the APA process

The new PS LA identifies three stages to the ATO's APA process: early engagement, APA application, and monitoring compliance.

Stage 1: Early engagement

Stage 1 will generally commence when a taxpayer initiates an APA request by completing an early engagement form. This stage is intended to involve a "robust and holistic strategic level review of the APA request and supporting documentation, including an examination of the relevant global value chain."[1] This statement provides insight into the increased rigor of the ATO's new APA process and confirms that taxpayers should expect a more thorough examination of their transfer pricing arrangements and global value chains than under the APA process set out in PS LA 2011/1.
URL: https://www.ato.gov.au/uploadedFiles/Content/LB_I/downloads/PGI_APAearlyengagement.pdf

Stage 1 involves three steps: triage, preliminary discussions, and an APA request review workshop. During the internal triage phase, the ATO triage panel examines information provided by the taxpayer and the ATO APA team, and decides whether the APA request should proceed further. Factors taken into consideration in making this decision include the taxpayer's tax and compliance history, performance under previous APAs, transfer pricing documentation, the value of the taxpayer's cross-border dealings, and other tax issues requiring consideration as part of the APA process.

During the second step, the ATO and the taxpayer hold preliminary discussions to explore the appropriate treatment of relevant cross-border dealings and any collateral issues. Finally, the APA request review workshop's objective is to assist the APA team leader to decide whether to invite the taxpayer to lodge a formal APA application.

The degree of rigor and amount of information necessary at this early stage of the APA process represents a key change from the ATO's previous APA program, and demonstrates the ATO's intention to understand more completely a taxpayer's business, international tax models, and cross-border dealings before it is prepared to invite a taxpayer to lodge a formal APA application.

Stage 2: APA application

The APA application stage starts once a taxpayer accepts the ATO's invitation to lodge a formal application. This stage involves analysis and evaluation of the taxpayer's APA application and supporting information by the ATO's APA team, negotiation of the terms of the APA by the ATO and the taxpayer (and the other tax authorities in bilateral and multilateral cases), and reaching agreement on the APA's terms.

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[1] Paragraph 10B of PS LA 2015/4.

The ATO's APA team is guided by TR 2014/8[2] on the documentation it can expect to review during this phase of the APA process. However, PS LA 2014/5 notes that, when verifying whether the proposed APA results in an arm's length outcome, the APA team may need to make further inquiries, such as additional information requests to the Australian taxpayer and/or its offshore affiliates, and interviews with key personnel.

This stage is not significantly different than that outlined under the ATO's previous PS LA on APAs, although in practice we have seen the ATO place greater emphasis on settling collateral (that is, non-transfer pricing) issues as part of the new APA program.

Stage 3: Monitoring compliance

Following agreement of the APA, the ATO monitors the taxpayer's performance under the agreement. This is facilitated by the taxpayer's preparation and lodgement of an annual compliance report detailing compliance with the APA terms. Again, this stage is not significantly different than that outlined under the ATO's previous PS LA on APAs.

Timing

An attachment to PS LA 2015/4 provides an overview of the end-to-end APA process, identifies key decision points, and sets out maximum timelines for stage 1 (six months) and stage 2 (18 months). Of some concern, from a timing and efficiency perspective, is the PS LA's acknowledgment (at paragraph 9D) that the APA process is not necessarily a linear one and that, in some cases, some steps may have to be repeated.

Simplified APA renewal process

Taxpayers seeking a straightforward renewal of existing APAs (when there are no material changes to the dealings covered by the APA, no proposed changes to the APA conditions, and no anticipated changes to the covered dealings over the renewed APA term) should be accepted into the ATO's "simplified APA renewal process."

Eligibility for this simplified process assumes there are no transfer pricing or other tax "complexities" associated with the taxpayer, such as migration of intellectual property offshore, the use of offshore hubs, push-down of debt into Australia, use of hybrid instruments, treaty abuse, transfer pricing outcomes inconsistent with arm's length outcomes, tax effective supply chains, or Part IVA issues, for example. In cases that may involve these issues, the simplified APA renewal process is unlikely to be made available, and relevant issues would typically be referred to other areas within the ATO for further consideration and potential review.

Recent experience in APA cases

The ATO's reasons for why taxpayers would enter into an APA[3] confirm the ATO's recent public statements that its APA program is "open for business," and the ATO continues to

[2] TR 2014/8 Transfer pricing documentation, and Subdivision 284-E.
[3] Paragraph 4 of PS LA 2015/4 lists specific factors that would make the ATO less likely to enter into an APA.

promote the program as a key cooperative compliance process and an integral part of its international tax strategy. Nevertheless, taxpayers should be aware of practical reasons why the ATO may not be prepared to enter into an APA. Examples[4] include:

- The presence of aggressive tax minimization structures in the multinational corporation's global value chain. Senior ATO personnel recently have stated that "[w]hile the APA program is open for business, [the ATO] won't rubber-stamp aggressive profit shifting structures,"[5] so "[a]ny company that [the ATO] thinks is involved in the more aggressive tax planning [the ATO is] not allowing onto the APA program."[6]
- The presence of collateral issues that affect the ATO's ability to enter into the proposed APA. Some APA requests are deferred by the ATO, subject to "a more appropriate" compliance exercise, including an ATO review or audit, to help establish the facts and tax issues before entering into an APA.[7]
- The arrangements that are the subject of the proposed APA appear to lack commerciality or are primarily tax driven (for example, restructures where the commercial benefits to the Australian entity are questionable).
- The value of the cross-border dealings is not material, or is a small portion of the taxpayer's total cross-border dealings.
- Taxpayers that are not sufficiently cooperative with the ATO. Some taxpayers have recently been taken off the APA program and placed into audit because "they were unwilling to supply the material that [the ATO] needed to vouch whether or not the transfer prices being paid were right."[8]

Practical takeaways

In the current environment of heightened interest in MNCs' cross-border related-party arrangements, taxpayers are likely to place a significant premium on certainty regarding their transfer pricing positions. Accordingly, APAs will continue to appeal to taxpayers as materially valuable assets – particularly because the ATO generally will not undertake active compliance efforts in relation to cross-border dealings that are the subject of an APA.[9]

It is certainly positive that, in releasing PS LA 2015/4, the ATO has reaffirmed its commitment to a principle-based approach to APAs, streamlined APA process and practices, and an improvement in taxpayer experience. Nonetheless, under PS LA 2015/4, taxpayers should

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[4] Paragraph 7 of PS LA 2015/4.
[5] Chris Jordan, Commissioner of Taxation, Commissioner's speech to the Tax Institute's 30th national convention, 19 March 2015.
[6] Mark Konza, ATO Deputy Commissioner – International, at the Senate Inquiry into Corporate Tax Avoidance, 22 April 2015.
[7] Mark Konza, ATO Deputy Commissioner – International, Interview with the Australian Financial Review, 3 April 2014, http://www.afr.com/news/policy/tax/tax-office-monitors-agreements-with-multinationals-20140403-ix8kf.
[8] Mark Konza, ATO Deputy Commissioner – International, at the Senate Inquiry into Corporate Tax Avoidance, 22 April 2015.
[9] Unless it has reason to believe the taxpayer has omitted or provided incorrect information that is material and relevant (see paragraph 25B of PS LA 2015/4).

enter the ATO's APA program with the expectation that, in comparison to the previous APA process, for some APAs the level of ATO scrutiny will be greater, particularly in the early stages of the process, and that the ATO will typically demand more information, particularly in relation to taxpayers' global value chains and collateral tax issues.

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China Issues Regulations on Cost Sharing Agreements

China's State Administration of Taxation recently changed its rules on cost sharing agreements, which now require Chinese taxpayers that enter into a CSA to register the agreement with the local tax authorities within 30 days of entering into the agreement.

China's State Council on May 14 released Guofa [2015] No. 27, "Decision of the State Council on Cancelling Items Requiring Non-administrative Approval." Further to a series of previous circulars, Circular 27 cancelled 49 items in total that previously required non-administrative approvals, including approval of CSAs.

Soon after Circular 27 was issued, China's State Administration of Taxation (SAT) promulgated SAT Bulletin [2015] No. 45, Bulletin on Standardizing the Administration of Cost Sharing Agreements, effective July 16, 2015, to implement the decisions of Circular 27 from the perspective of the tax administration.

Key Changes to Regulations

Approval authority: The prevailing CSA regulations before Circular 27 and Bulletin 45 entered into effect primarily referred to the relevant articles in Guoshuifa [2009] No. 2 (Circular 2) and the Enterprise Income Tax Law. Article 69 in Chapter 7 of Circular 2 regulated the approval authority of CSAs, and stated as follows:

> *Article 69: Enterprises must submit a CSA to the SAT level by level for recording within 30 days of concluding the CSA. Tax authorities must report level by level to the SAT for approval to determine whether the CSA complies with the arm's length principle.*

In Circular 27, Item No. 46 in the list of cancelled non-administrative approvals refers to "the approval of whether a CSA complies with the arm's length principle." Effective July 16, 2015, Bulletin 45 repealed Article 69 of Circular 2.

From ex-ante approval to ex-post supervision: As stated above, prior to the release of Circular 27 and Bulletin 45, taxpayers had to submit a CSA to the SAT for recording and to obtain the SAT's formal approval regarding the agreement's compliance with the arm's length principle. Approval from the SAT was necessary for taxpayers to implement a CSA and to enjoy the corresponding tax treatments associated with CSAs, including withholding income tax, turnover tax, etc. from the perspective of China taxation.

The issuance of Circular 27 and Bulletin 45 resulted in the repeal of the SAT's administrative responsibility or power of ex-ante approval of CSAs regarding whether relevant arrangements comply with the arm's length principle. However, Bulletin 45 requires China's tax authorities to strengthen ex-post supervision and follow-up administration of CSAs. Note that, under the current Chinese transfer pricing regulations, the statute of limitation for transfer pricing adjustments in China is 10 years.

The SAT's supervisory measures include:

- Audit investigations and special tax adjustments will be carried out against CSAs that do not comply with the arm's length principle, or if the CSA's costs are not commensurate with the benefits accrued; and
- During the execution of a CSA, if the actual benefits accrued by the participants do not match their respective share of the costs, balancing adjustments should be performed, and the tax authorities will conduct a tax investigation and special tax adjustments in cases when the necessary balancing adjustment is not performed.

Bulletin 45 further strengthened the compliance obligations of taxpayers participating in CSAs, including but not limited to the following:

- An enterprise must submit copies of a CSA to its local in-charge tax authority within 30 days from the date the CSA is signed or amended;
- An enterprise that signed or amended a CSA with its related party(ies), regardless of whether the CSA is executed or not, must submit PRC Annual Related Party Disclosure Forms regarding its transactions with related party(ies) as an addendum to its annual enterprise income tax filings.

In addition, according to Article 74 of Circular 2, during the execution of a CSA an enterprise must prepare and maintain contemporaneous documentation, which should include total annual costs within the scope of the CSA, with breakdown, actual cost allocation of each participant in the CSA, update analysis of reasonably anticipated benefits (RABs) against the actual costs and benefits outcome, as well as corresponding balancing adjustments.

Overall, the newly released regulations aim to simplify and facilitate the CSA administration process, and to govern taxpayers' compliance regarding their participation in and execution of CSAs. Nevertheless, it should be pointed out that the SAT has not yet released any clear regulation as to whether and how an enterprise is to receive the relevant tax treatments during the execution of CSAs in respect of shared costs and balancing adjustments, including the treatment of withholding tax and turnover tax.

Commentary

Bulletin 45 was promulgated to implement Circular 27 from the perspective of the tax administration, in the context of government transformation to streamline the administration of CSAs and delegate power. Bulletin 45 clarifies the procedural administration of CSAs, and the transition from ex-ante approval by the SAT to ex-post supervision.

There is no doubt that the newly released regulations will facilitate taxpayers' participation in CSAs from a procedural perspective, in accordance with China's transfer pricing regulations, while requiring taxpayers to prepare corresponding supporting files, technical analyses, and ex-post compliance documents. However, based on our understanding of the relevant tax practice in China, potential risks and uncertainties in practice are worthy of taxpayer consideration, including the following issues.

Outstanding Regulatory Issues

Although Bulletin 45 stresses the arm's length principle and the commensurate-with-income principle, it merely repeats statements of the two principles stipulated in the current Circular 2.[10] However, Bulletin 45 does not include discussions of some key technical issues in practice, for example, how to determine the RABs, and the pricing of buy-in and buy-out payments. These technical issues are crucial to relevant transfer pricing analysis and have significant impact on determining the arm's length nature of CSAs.

More detailed guidance and regulations on outstanding issues may be provided in the forthcoming revised Circular 2, which is now under review by the SAT.

Potential Transfer Pricing Audit Risk

From the aforesaid changes to the CSA regulations, it may be concluded that the repeal of ex-ante approval of CSAs by the SAT is closely associated with an increase in ex-post supervision and administration of CSAs. In the future, the Chinese tax authorities may be expected to supervise and monitor taxpayers' execution of CSAs more closely through the review of the PRC Annual Related Party Disclosure Forms and contemporaneous documentation for CSAs under execution.

The Chinese tax authorities would have the legal right to review and challenge the transfer pricing analysis in the CSA-related compliance documents mentioned above. Therefore, it is imperative for taxpayers to actively manage and arrange the relevant compliance work to ensure the ongoing and effective recognition of their CSAs by the Chinese tax authorities. Also, because some of these issues regarding the application of the arm's length principle to CSAs, especially technical issues such as the analysis of RABs and the pricing of buy-in and buy-out payments, may still be new for most local tax authorities in China, we foresee that the Chinese tax authorities may raise inquiries and even challenges in their review and examination of actual CSA cases. The tax authorities may defend their taxation positions from technical perspectives with reference to recent international opinions, such as relevant

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[10] See Article 66, Article 75 etc. of Circular 2

discussion drafts issued under the OECD's base erosion and Profit Shifting (BEPS) action plan. Hence, in practice, taxpayers may encounter stricter compliance requirements and ex-post investigation risks.

In consideration of the above, we believe taxpayers must prepare all supporting materials for the entire lifespan of the CSAs, covering the arrangement period and subsequent CSA execution period, documenting CSA contents and particular articles, analysis of whether the arrangement of a CSA is in compliance with the commensurate-with-income principle and the arm's length principle, as well as the consequent balancing adjustments in case the costs shared do not match the actual benefits received. For large CSAs, taxpayers may consider applying for an advance pricing arrangement (APA) under China's transfer pricing regulations, to effectively mitigate ex-post investigation risks.

Relevant Tax Treatments and Non-trade Outbound Remittance

As discussed, the above changes to the regulations abolished the SAT's administrative authority to ex-ante approval of whether a CSA complied with the arm's length principle. However, as stated above, without further clarification and regulations, local tax authorities may not respond actively to taxpayers with regard to the grant of relevant tax treatments relating to CSAs, so that taxpayers may not receive and enjoy the relevant tax treatments in a timely manner. In fact, whether the CSA-related tax treatments could be timely and continuously enjoyed by taxpayers throughout the entire CSA execution period is probably the most critical concern for taxpayers when they consider whether to participate in a CSA.

It is also uncertain whether local tax authorities would provide to taxpayers in a timely basis the relevant tax clearance certificates or similar documents for purposes of outbound remittances during the CSAs' course of execution. Therefore, Circular 27 and Bulletin 45 may still leave the aforesaid obstacles to taxpayers in aspects of relevant tax treatments as well as non-trade outbound remittances.

To sum up, Circular 27 and Bulletin 45 aim to streamline the administrative process of CSAs in China, while taxpayers contemplating to participate in CSAs should pay attention to the remaining uncertainties and practical obstacles, plan and prepare ex-ante and ex-post compliance work, keep pace with updates of related laws and regulations, and seek professional advice when necessary.

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Spain issues new corporate income tax regulations, including CbC reporting requirements

Spain's Royal Decree 634/2015, issued on July 2015, sets forth new corporate income tax regulations. The main amendments made by the regulations relate to transfer pricing, including new country-by-country (CbC) reporting obligations and other relevant amendments to the reporting and documentation obligations of taxpayers.

The corporate income tax regulations generally are retroactively applicable to tax periods beginning 1 January 2015, although the CbC reporting obligations and the other transfer pricing reporting and documentation requirements for entities and groups with an aggregate net turnover of EUR 45 million or more will apply for tax periods beginning from 1 January 2016.

CbC Reporting Obligations

The new CbC reporting obligations are in line with the OECD work on the base erosion and profit shifting (BEPS) project and action 13 of the BEPS action plan, which sets forth guidelines for transfer pricing documentation on a CbC basis.

The CbC reporting obligations, as implemented in Spain, will apply to the following:

- Spanish parent entities of a multinational group, provided the consolidated group's gross income in the immediately preceding taxable year exceeds EUR 750 million; and
- Spanish subsidiaries and permanent establishments that are, directly or indirectly, held by a foreign parent entity, where:
  - The Spanish subsidiary or permanent establishment has been appointed by the foreign parent entity to prepare the CbC documentation; or
  - The foreign parent entity is tax resident in a country that has not established CbC reporting obligations with similar terms to those of Spain or has not signed an automatic exchange of information agreement with Spain in relation to these obligations, or has signed such an agreement that systematically is breached.

The CbC reporting basically will include the following information on an aggregate basis per country:

- Group's gross revenue, distinguishing between revenue from related and unrelated parties;
- Accounting results before corporate income tax, or a tax of a similar or analogous nature;
- Corporate income tax (or tax of a similar or analogous nature) effectively paid, including withholding taxes;
- Corporate income tax (or tax of a similar or analogous nature) accrued, including withholding taxes;
- Share capital and equity at the end of the fiscal year;
- Average number of employees;
- Tangible assets, real estate investments, and receivables;

- List of resident entities, including permanent establishments, and the main activities these are engaged in; and
- Other information that is considered relevant and, if applicable, an explanation of the data included in such information.

The reporting must be completed within a 12-month period from the end of the taxable year to which the CbC report relates. A specific tax form will be released by the tax authorities for this purpose.

Transfer Pricing Documentation Requirements

Entities may be required to prepare both a master file and a local file containing transfer pricing documentation. However, entities belonging to groups whose net turnover is below EUR 45 million will not be required to prepare the master file.

Additionally, the obligation to prepare a local file is simplified for those entities/groups whose net turnover does not exceed EUR 45 million. However, information on certain specific transactions will not be excluded from the reporting obligation.

Group Information (master file): In general terms, the information to be reported includes the following:

- **Information on the group's activities:** This requires a description of the main activities and geographical markets in which the group operates, its main profit sources and information on the supply chain of those goods and services that account for at least 10% of the group's turnover. This also includes a description of any business restructuring transactions and the acquisition/assignment of significant assets, among other data.
- **Information on the group's intangible assets:** This requires a general description of the group's overall strategy for the development, ownership and exploitation of intangible assets, including the location of principal R&D facilities and the location of R&D management, and other relevant information.
- **Information on financial activities:** This requires a general description of the group's financing, including its main financing agreements with third parties. This also includes, among other data, the identification and addresses of the group entities carrying out financial activities.
- **Group's financial and tax positions:** This requires a list and brief description of the group's existing advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

Taxpayer Information (local file): The main new items to be reported concerning the local file include the following:

- Details on the organization's structure and reporting paths;
- A detailed description of the business, strategy and restructurings and transfers of intangibles;
- Information on main competitors;
- Information on APAs;

- A matching analysis of the data reported in the financial statements versus the data used in applying the transfer pricing methods, when this is deemed relevant; and
- Comparable financial data that has been used, and the relevant source of information.

Other Notable Modifications

Secondary adjustments: Under certain conditions, the "secondary adjustment" (broadly speaking, the taxation of a deemed gain at the level of an acquirer that has paid an amount lower than the market value, or a gain at the level of a transferor that has received an amount exceeding the market value) will not be regularized, provided the relevant taxpayer reimburses the relevant amount to its counterparty.

APAs: The main change is that APAs now also may apply to transactions carried out in tax periods that ended before their issuance, provided the period has not become barred by the statute of limitations.

Special depreciation plans: These may be agreed upon with the tax authorities at any time during the depreciation period (and not necessarily during the first three months).

Formal obligations of the fiscal unity regime: These have been modified to reflect the new consolidation parameters provided by Law 27/2014. This includes, among other items, the obligation to appoint a representative of the group that is resident in Spain, where the parent entity is a nonresident.

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WCO Publishes Guide to Customs Valuation and Transfer Pricing

In another step toward clarifying the link between customs valuation and transfer pricing for global customs authorities and importers, the World Customs Organization (WCO) on June 24 published a new guidance document titled the "WCO Guide to Customs Valuation and Transfer Pricing." As noted in the guide, up to 60 percent of all international trade takes place between related parties, which makes this guide a must-read for all importers of goods purchased from related suppliers.

Over the past decade, the WCO and the Organization for Economic Cooperation and Development (OECD) have collaborated regularly on the differences between transfer pricing rules and related-party customs valuation rules. At the same time, many customs authorities around the globe have heightened their scrutiny of related-party import transactions, and have increasingly rejected the acceptability of transfer prices as a basis for customs values. Moreover, while the related-party customs valuation rules are generally consistent among World Trade Organization member states, variances in their interpretation and application by customs authorities have emerged, causing inconsistent results and compliance management challenges for global importers.

With the publication of this guide, the WCO seeks to reduce the burden on businesses endeavoring to satisfy dissonant transfer pricing and related-party customs value rules by encouraging a more consistent approach among customs authorities with respect to accurately determining duty liabilities. To this end, the guide sets forth guidance on navigating and interpreting the rules governing the relationship between customs valuation and transfer pricing in related-party transactions. In addition to setting forth a primer on transfer pricing rules and related-party customs valuation rules, the guide considers two key areas that are often the subject of confusion and debate: (1) the extent to which information found in transfer pricing documentation can be useful to customs in determining whether the price declared for imported goods has been influenced by the relationship between the parties; and (2) how transfer pricing adjustments should be accounted for when determining final customs values.

This new guide encourages customs and tax authorities to establish communication and exchange information to ensure that each has the broadest picture of a company's business and compliance record, so that they can make informed decisions on the correct revenue liability. It also encourages them to consider how transfer pricing documentation may be used to support customs valuation, and recommends practices for customs valuation and tax policymakers as well as business administrators in approaching this issue.

The guide indicates that, in the future, the WCO's Technical Committee on Customs Valuation will provide examples of situations in which transfer pricing data has proven useful to customs authorities when examining related-party transactions, although no time frame has been indicated for the publication of such information. The guide also indicates that the WCO, the OECD, and the World Bank intend to conduct regional workshops to bring authorities together to raise awareness and share experiences at the national, regional, and international level.

Related-party customs valuation, and the treatment of transfer prices and transfer pricing adjustments by global customs authorities, continues to be an evolving area of customs enforcement and compliance, and one that depends on coordination between tax and customs administrators within a business. Although developments over the past decade have resulted in an increased awareness of the compliance challenges presented by the complex customs value rules governing related-party import transactions, much ground remains to be covered by customs authorities and importers alike in achieving a consistent approach to enforcement and management in this area. This guide presents another step in the right direction toward facilitating the link between transfer pricing and customs valuation.

The full text of the guide can be found on the WCO website.
URL: http://www.wcoomd.org/en/topics/key-issues/revenue-package/~/media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx

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UK Tribunal Finds for Tax Authorities in Derivatives Case with Transfer Pricing Implications

The UK's First-tier Tribunal (FTT) on July 14 rendered a decision in the *Abbey National Treasury Services Plc v HM Revenue & Customs (HMRC)* ("ANTS") case in favor of HMRC. Although the case considered broad points on the taxation of derivatives (and involved a scheme subject to the UK's disclosure regime), it is interesting to transfer pricing professionals because the FTT heard arguments concerning whether the issue of shares between two UK companies in the same group was "a provision by means of a transaction" and therefore within the UK transfer pricing rules.

The point at issue concerned a £160 million debit arising from ANTS' derivative contracts and claimed as a tax deduction.

The tribunal found that a transfer pricing adjustment should be made. It held that UK transfer pricing rules have broad ambit, and that a share issue could amount to a provision, that the issue of the tracker shares in this case met the conditions in paragraph 1.37 of the 1995 version of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and could be recharacterized, and that the recharacterized transaction was that no shares would have been issued.

This case has several important features for UK transfer pricing:

- The FTT has confirmed that Article 9 of the OECD Model Tax Treaty should inform the interpretation of UK transfer pricing rules.
- The FTT has again taken the widest view of what can amount to a "provision." In light of this case and an earlier case (*DSG Retail Ltd and others v HMRC*), if something of value has been received (cash, opportunity, advantage) then this is likely to amount to a "provision" for UK transfer pricing purposes.
- The transfer pricing rules will be enforced between UK companies and, if necessary, before the courts, if a tax advantage is sought from mispricing.
- The FTT has concluded that there is no impediment to applying UK transfer pricing rules if value is transferred in a share issue; the tracker shares did amount to *commercial and financial relations* for purposes of Article 9 and therefore for UK transfer pricing rules.
- By extension of the logic in this case, other matters of a shareholder-like nature not commonly thought to affect transfer pricing analysis (partnership agreements, for example) should be reviewed carefully to see if there is any "provision" within the scope of the UK transfer pricing rules.
- The attempt to compare tracker shares with the issue of bonus shares was rejected, because the two have different effects and therefore are not comparable.
- Regarding the arm's length price for tracker shares:
    - HMRC argued: "…[t]here was no basis on which a payment of £1,000 to receive cash flows with a net present value of £161 million could be seen as an arm's length transaction." This emphasizes the importance of exercising professional judgement. Regardless of the strength of a valuation method, if it produces an incredible result then it is not a credible basis of valuation, or "most appropriate method" for pricing the transaction.

- It was accepted that the issue of tracker shares was a transaction within paragraph 1.37 of the 1995 OECD transfer pricing guidelines and therefore could be recharacterized. The recharacterized, arm's length transaction would be that the shares would not be issued at all. Therefore, the debit arising is "nil."

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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 to have a Deloitte Tax professional contact you.