Deloitte.

Global Transfer Pricing

Arm's Length Standard

December 2015

In this issue:

Australian court rules in favor of tax authorities in Chevron transfer pricing case

The Australian Federal Court on 23 October issued its much anticipated decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* ([2015] FCA 1092), upholding transfer pricing assessments against Chevron Australia Holdings Pty Ltd (CAHPL) related to interest payments made to its US subsidiary, Chevron Texaco Funding Corporation (CFC), under an intercompany loan arrangement.

CFC lent CAHPL the Australian dollar equivalent of USD 2.5 billion on an unsecured basis at an interest rate of AUD LIBOR plus 4.14 percent under a credit facility agreement entered into in June 2003 with a maturity date of 30 June 2008. CFC had raised the funds at rates of interest at or below USD LIBOR (approximately 1 percent to 2 percent) through an issuance of USD commercial paper with a credit guarantee provided by Chevron Inc., the group's ultimate parent.

The court held that CAHPL had not shown that the interest paid under the credit facility agreement was equal to or less than arm's length. CAHPL therefore did not prove that the amended assessments imposed by the commissioner of taxation under Division 13 were excessive.

The case was extremely complex, involving multiple facets of tax law, and was heard over 21 court days, making it one of the lengthiest tax cases in Australia. The case involved more than

20 witnesses and experts (from corporate banking, rating agencies, academia, the oil and gas industry, and transfer pricing specialists).

The Big Picture

The *Chevron* case should be seen in context as the first big-dollar transfer pricing case taken by the Australian Taxation Office (ATO) to the Federal Court. It is also the first test of the retrospective Subdivision 815-A laws introduced by the Australian government in 2012, explicitly at the Australian Taxation Office's (ATO's) request to shore up Australia's transfer pricing regime after the loss by the ATO in the *SNF Australia* case in the Full Federal Court (which was argued under the old Division 13 regime). It also should be seen as part of the ATO's wider messaging that it is willing to take multinationals to court on transfer pricing, notwithstanding the ATO's general preference to reduce extensive "paper wars" with multinationals and agree matters outside of a court context.

This win may embolden the ATO to pursue transfer pricing audits, particularly for inbound financing arrangements. It is also relevant that while the dollar amounts at stake in this case are considerable, as a consequence of major capital project developments in the resources and infrastructure sectors in Australia in recent years, there are other large funding arrangements in the market that may now be in the ATO's sights.

From a global perspective, the case has significance as an interpretation of the arm's length principle in the context of financing, and is probably the most significant case since the *GE Capital Canada Inc.* (2009) case in Canada. Issues common to both cases include whether the potential for credit support by parent/affiliate entities (in the absence of legally binding guarantees) should be considered under the arm's length principle, and the appropriate benchmarking approach for loan/guarantee fee transactions. In addition, global commentators will be interested in the judge's view on the ability of the arm's length principle to look beyond the legal form of a transaction and determine pricing based on the actual conduct of the parties, and as discussed below, whether such an approach is in fact a "reconstruction" or simply pricing the actual arrangement.

The court's view on all of the above issues, and potentially the views of the Full Federal Court if the case is appealed, may have resonance with the OECD as it further considers (in the context of the BEPS project) the application of the arm's length principle to intragroup financing arrangements in 2016.

The facts

The judgement provides limited detail of the relevant facts; however, it appears that the arrangements included the following:

- CFC was a wholly owned subsidiary of CAHPL. CFC appears to be a resident of the United States and not a resident of Australia
- CFC borrowed USD 2.5 billion from the commercial paper market at rates of interest at or below USD LIBOR (approximately 1 to 2 percent)
- CFC obtained a guarantee from Chevron Inc, the ultimate parent of the group

- CFC provided an intercompany loan to CAHPL for the AUD equivalent of USD2.5 billion, under the credit facility agreement
- The interest rate under the credit facility agreement was AUD LIBOR plus 4.14 percent
- CAHPL drew down funds of approximately USD 2.5 billion in two tranches. Interest payments were made through "debits to the US dollar bank account …calculated by reference to the AUD principal amount borrowed"
- It appears that there was no interest withholding tax on the interest payments from CAHPL to CFC, presumably as a result of Section 128F(8)
- During cross-examination, it was indicated that "CFC was not taxable in the US" on the interest income
- As a result of the interest differential, CFC generated profits and it paid dividends to CAHPL, which were exempt from tax in Australia
- CAHPL in turn paid dividends to its shareholder

Summary

Although this case was based on Australia's former transfer pricing rules, it is expected to have a significant impact on the future interpretation of the arm's length principle in Australia, not only in relation to financial arrangements but also in respect of other related-party transactions

A discussion of the key implications follows.

Article 9 not a separate taxing power: Article 9 (the associated enterprises article in the relevant double tax treaty) does not confer a separate or alternative taxing right outside the scope of the domestic transfer pricing rules, thereby highlighting the importance of the retrospective nature of Subdivision 815-A. This finding is contrary to the ATO's long-held view, and consistent with obiter dicta in the *SNF Australia* case.

Broad view of consideration: The term "consideration" in Division 13 is broader than just the price (interest rate), and allows the commissioner to make adjustments to other factors (security and loan covenants in this case) that could have an impact on the price.

Can substitute arm's length conditions: In applying the hypothesis required under Subdivision 815-A, the actual conditions that operated between the relevant parties must be compared with those conditions that might be expected to operate between independent parties dealing at arm's length. In doing so, the court held that the commissioner took into account alternative conditions (such as security over assets and other financial covenants) without applying the specific reconstruction provisions. Given the similarities between Subdivision 815-A (which applies from 2004 to 2013) and the current transfer pricing provisions in Subdivision 815-B, this finding suggests that the commissioner has extensive powers to "rewrite" or "recharacterize" elements of related-party transactions, without the need to prove that the specific requirements for reconstruction (in s 815-130) are met. This principle could have implications beyond financing to other types of transactions (such as intellectual property, services, tangible goods) whereby the commissioner or the court can "rewrite" or "recharacterize" certain matters in determining the arm's length pricing.

Loan was “not sustainable”: In cross-examination, an employee of CAHPL accepted that the loan of the Australian dollar equivalent of USD2.5 billion at an interest rate of 8.97 percent was “not sustainable.”

Implicit credit support: The court considered whether “implicit credit support” provided by associate or parent entities should be taken into account in applying the arm’s length principle. Justice Robertson accepted CAHPL’s submission that such implicit credit support had “little if any impact on pricing by a lender in the real world.”

Expert witness evidence “unrealistic”: The absence of loan covenants and security was a significant factor in the court’s findings. The fact that the key expert witnesses for CAHPL did not price a loan with security and financial covenants meant that the court found the evidence to be “unrealistic.” This highlights the requirement for all terms and conditions included in related-party agreements to be arm’s length, robust comparability analysis, and also for transfer pricing analyses to be “founded in the statutory language” of the relevant provisions.

Onus of proof: The onus of proof is on the taxpayer to show that the ATO’s transfer pricing determinations are incorrect and that the tax assessments are therefore excessive. The court focused on whether the taxpayer had discharged this burden of proof, and was not able to conclude that the taxpayer had shown the ATO’s assessments to be excessive.

Currency: Given the substantial impact of the currency of a loan on the interest rate, it is significant that the potential impact of foreign exchange gains and losses for the borrower was accepted as valid reason for denominating the loan in Australian dollars.

Evidence from internal communications: In determining that a scheme benefit applied, and therefore the application of 25 percent penalties, evidence from internal emails and communications between CAHPL staff and the Chevron head office were critical in the commissioner’s case.

From a global perspective, this case may have wider impact given the current lack of transfer pricing guidance on financing transactions. Furthermore, it may influence the development of the OECD’s views as it progresses with its plan to issue more guidance in this area in 2016.

There seems to be a high likelihood of appeal, potentially on issues such as whether Division 13 allows a broad interpretation of the term “consideration” to include security and other financial covenants, and under Division 815, whether the court is inappropriately “reconstructing” the transaction.

Below is a detailed view on specific issues covered in the case, and observations on what multinationals may want to do regarding this decision.

Division 13

Arm’s length consideration: Justice Robertson referred to the Full Federal Court’s decision in *SNF* and accepted its findings in that case in relation to the statutory hypothesis.

However, His Honour rejected CAHPL's contention that the implication of *SNF* was that the hypothetical inquiry required the court to ignore all attributes and features of the taxpayer (such as membership in a particular industry or status as member of a corporate group).

Justice Robertson found that if the property (under the credit facility agreement) had been acquired under an agreement between independent parties dealing at arm's length with each other, the borrower would have given security and covenants (operational and financial) and as a result, the interest rate would have been lower. In his view, "consideration" includes more than just price: it also includes such features as security and covenants that the borrower would have provided to an arm's length lender.

Justice Robertson held that the correct approach to the inquiry under s136AD(3)(c) required the court to address an agreement between two parties independent of each other, neither party being an actual party to the actual loan. It was found that the hypothetical exercise should not depart from reality more than is necessary for the hypothesis and it should remain close to the actual loan. Justice Robertson further stated that the statutory hypothesis must include what has been shown on the evidence to be relevant to the market in question. In the present case, the judge held that it must therefore be a factor that the borrower was in the oil and gas exploration and production (E&P) industry.

Whether "independent" should mean "stand-alone": Justice Robertson held that s136AAD(3)(d) did not require that CAHPL be considered a stand-alone company; the provision does not require that the term "independent" be construed as entirely independent of the group rather than just independent of the lender. It was held that for purposes of the inquiry, the hypothetical independent parties should have the characteristics relevant to the pricing of the loan so as to enable the hypothesis to work. So for example, the hypothetical borrower would also be assumed to be a subsidiary of a major multinational.

Subdivision 815-A – Considered in the alternative

Constitutional validity of Subdivision 815-A: CAHPL challenged the constitutional validity of Subdivision 815-A, arguing that ss 815-10 to 815-30 were invalid because they imposed an arbitrary exaction and therefore did not answer the description of a law with respect to taxation for purposes of s51(ii) of the Australian Constitution.

Justice Robertson rejected all of CAHPL's arguments in relation to the constitutional validity of Subdivision 815-A and held that the challenge failed.

Preconditions to the making of the Subdivision 815-A 2012 determinations: Justice Robertson held that Article 9 of the US-Australia income tax treaty is a provision relevantly corresponding to Article 9 of the UK-Australia convention. The judge held that despite different wording in the two articles, it is sufficient that Article 9 of the UK-Australia convention deals with "associated enterprises" as does Article 9 of the US-Australia income tax treaty, and that the "gist" of each article is the same. Therefore, the court held, Article 9 of the US-Australia income tax treaty answers the definition of an "associated enterprises article" in s815-15(5)(b).

Justice Robertson also rejected an argument by CAHPL that the Subdivision 815-A determinations were invalid because, in making them, the commissioner did not make a proper attempt to determine whether CAHPL had obtained a “transfer pricing benefit” or to calculate the amount of that benefit. The judge held that the argument failed at the evidentiary level and that the mere fact that amounts in the Subdivision 815-A determinations were the same as those in the Division 13 determinations was insufficient to sustain this argument.

Transfer pricing benefit: Justice Robertson held that the correct approach is to identify the conditions mentioned in Article 9 and then ask if there was an amount of profits that, but for those conditions, might have been expected to accrue to the entity but that has, by reason of those conditions, not so accrued. This involves a comparison of the conditions that operate between CAHPL and CFC in their commercial or financial relations, and whether those conditions differ from those conditions that might be expected to operate between independent entities dealing wholly independently with one another. Justice Robertson rejected CAHPL’s submission that, for purposes of this inquiry, Article 9 permits only an adjustment to the price of a transaction (that is, the interest rate) and that the commissioner is not allowed to rewrite the terms and conditions of the loan agreement. The court held that a broader range of conditions may be considered. The commissioner set out 11 conditions that differed from those that might be expected to operate between independent enterprises dealing wholly independently with one another. These conditions included the terms and conditions of the loan agreement, the duration and currency of the loan, and the fact that there were no covenants. Justice Robertson accepted and took into account the majority of these identified conditions to ultimately conclude that, but for the conditions operating between CAHPL and CFC, which differ from those that might be expected to operate between independent parties dealing wholly independently with one another, an amount of profits might be expected to have accrued but did not so accrue; as a result, CAHPL failed to show that the assessments were excessive.

The judge also found that it was not necessary for the commissioner to explicitly state, for each identified condition, precisely how it would differ from the condition that might be expected to have operated between independent enterprises, or how each identified condition was said to have impacted the pricing of the loan. Nor was it a requirement that the “arm’s length” conditions be explicitly identified by the commissioner. The judge found that it was enough for the commissioner to identify (as he did in this case) which conditions operate between the two enterprises that differ from those that might be expected to operate between independent enterprises dealing independently with one another.

Pricing & Economic Issues

Currency: Justice Robertson accepted CAHPL’s evidence that the borrowings were denominated in Australian dollars to avoid or limit foreign currency gains and losses to CAHPL. The judge did not accept the commissioner’s argument that the loan would not have been denominated in Australian dollars if it had been entered into by independent enterprises dealing wholly independently with one another.

In different factual circumstances, a court may conclude that the currency of the actual loan differed from the conditions that may be expected to operate between independent parties dealing independently.

As a practical consequence, it continues to be important to be able to justify the commercial basis for all terms and conditions of an intercompany loan, including currency.

Implicit support: Justice Robertson accepted the commissioner’s submission that there was no legislative warrant for ignoring affiliation between a hypothesized party to a transaction and other members of that party’s group of companies (that is, implicit support may be generally relevant when assessing a borrower’s credit rating). Notwithstanding this, on the facts of the present case Justice Robertson found that the evidence showed that implicit support had very little, if any, impact on pricing by a lender in the real world.

The consideration of the relevance of implicit support appears consistent with the new OECD guidance to be inserted into Chapter 1 of the OECD transfer pricing guidelines (paras 1.164 to 1.167) regarding group synergy benefits in a financial transaction context.

Irrelevance of rating agency practices: Justice Robertson held that the question of the borrower’s credit rating should be considered from the perspective of a lender, and that a commercial lender would not approach this question in the same way as would a credit rating agency.

Accordingly, the practices of rating agencies were not considered to be relevant.

This approach can be contrasted with that in the *GE Capital Canada* transfer pricing case regarding guarantee fees, where the judge also accepted the relevance of implicit credit support, but placed more emphasis, based on the facts of that case, on the impact of such support (a three-notch upgrade in credit rating). The judge in the *GE Capital Canada* case also generally supported credit rating agency practices as relevant to determining the arm’s length price (for the guarantee fee under consideration).

Other issues

Whether Article 9 confers a separate taxing power: Justice Robertson found against a long-standing view of the Australian tax authorities in holding that Article 9 does not confer a separate taxing power on the commissioner. The judge found that the authorities established that the associated enterprises article allocates the taxing power between the treaty parties, or limits the already existing domestic taxing power of one of the treaty parties to avoid potential double taxation, but does not confer any power to assess on the assessing body. The commissioner was therefore unable to rely on Article 9 independently of the transfer pricing provisions in the domestic legislation.

The decision on this issue is significant in that it contradicts a long-held view that the associated enterprises article of Australia’s double tax agreements confers an independent power on the commissioner to impose tax. As a result of the decision on this issue, Subdivision 815-A has greater importance for the commissioner in that he or she will no longer be able to rely on Article 9 in the absence of Subdivision 815-A.

Validity of Division 13 determinations: One of CAHPL’s key arguments in its primary case was that the Division 13 determinations were invalid or inoperative and therefore could not be relied upon by the commissioner to support the Division 13 amended assessments. The basis of CAHPL's contention was grounded in the lack of authority of the particular ATO officer who made the determinations in dispute.

Justice Robertson held that the lack of authority of the ATO officer to make the determinations under Division 13 did not mean that the determinations were a nullity. The judge followed the WR Carpenter case in finding that the only relevant question is whether the assessments are excessive; the court will not look behind the assessment-making process to test the actual authority or actions of ATO officers.

The court held that "since s177(1) establishes, on the production of a notice of assessment under the hand of an officer there specified, the 'due making' of the assessments, a defect of the kind presently under consideration in a determination under s136AD(3)(d) which forms part of the making of the assessments does not demonstrate excessiveness of the assessment."

Penalties

Justice Robertson accepted the commissioner's submissions as to "scheme benefit": that is, apart from the scheme, it was reasonable to expect that CAHPL would not deduct the interest under the credit facility agreement but instead would have borrowed at an arm's length interest rate and deducted that lower interest expense. Further, it was reasonable to conclude that CAHPL entered into the credit facility agreement for the dominant purpose of obtaining a "scheme benefit."

Internal emails and communications between CAHPL staff and the Chevron head office were critical in assisting the commissioner to persuade the court to draw this conclusion.

As a result, the court accepted that penalties of 25 percent of the scheme shortfall amount could be imposed.

Appeal

Given the complexity of the case and the tax dollars at stake, there is a high likelihood that CAHPL will appeal.

What should multinationals do now?

Multinationals with intragroup financing arrangements should review their positions against this judgement, particularly having regard to the issues of:

- Delineation of the intercompany transactions in the context of the law. For example, review whether the characteristics of the transaction are consistent with the substance and conduct of the parties before selecting and applying the most appropriate transfer pricing methodology
- Implicit credit support – is this an issue that should be considered in the pricing?
- Security – would an arm's length loan have been secured? It would be relevant to consider if other third-party financing is in place, such as senior bank debt
- Currency, and the commercial basis for the choice of currency of intercompany loans

- Strength of the comparability analysis, having regard to the actual conditions of the arrangement.

Many issues raised in this case are not confined to financing. The judge's approach to replace aspects of the intercompany transaction with features that would have happened at arm's length in the market will have relevance beyond financing. Consider, for example, a sale of hard-to-value intellectual property, or a license of intellectual property to associates, where a key question will be how parties acting at arm's length would have structured the terms of the transaction. Multinationals should consider this, and the broader "reconstruction" powers under Subdivision 815-B, in any transfer pricing analysis.

— Geoff Gill (Sydney)
Partner
Deloitte Australia
gegill@deloitte.com.au

Ockie Olivier (Perth)
Partner
Deloitte Australia
oolivier@deloitte.com.au

James Fabijancic (Melbourne)
Legal Practitioner Director
Deloitte Lawyers Pty. Ltd.
jfabijancic@deloitte.com.au

Colin Little (Sydney)
Director
Deloitte Lawyers Pty. Ltd.
colittle@deloitte.com.au

Soulla McFall (Melbourne)
Partner
Deloitte Australia
smcfall@deloitte.com.au

John Bland (Brisbane)
Partner
Deloitte Australia
jbland@deloitte.com.au

Deadlines to Preserve Taxpayer Rights to Request Competent Authority Assistance to Relieve Double Taxation

Transfer pricing continues to be the top enforcement priority of tax authorities around the world, and one of the major risks for many multinationals. With foreign tax authorities aggressively asserting transfer pricing deficiencies, many taxpayers are receiving proposed adjustments regarding intercompany transactions. For this reason, it is imperative that taxpayers understand the actions required to preserve the right to request competent authority assistance to relieve double taxation.

Competent authority assistance for double taxation is provided under the mutual agreement procedure (MAP) article of the relevant tax treaty. To obtain relief from double taxation, the United States' and other countries' competent authorities must be notified of the proposed adjustments, or a request for MAP assistance must be filed, within specified deadlines. In the case of an IRS-initiated adjustment, the foreign tax authority must be notified, and in the case of a foreign-initiated adjustment, the IRS must be notified. Failure to make the appropriate filings can result in the IRS or foreign tax authority denying the taxpayer's request for competent authority relief to eliminate double taxation. In addition, taxpayers should not sign closing agreements with the tax authorities if they intend to request competent authority assistance, because doing so may limit their ability to obtain relief from double taxation.

In 2013, 70 percent of new cases related to foreign-initiated adjustments. Given the ever-increasing aggressiveness of foreign tax authorities, taxpayers must be increasingly vigilant regarding the treaty deadlines to protect the right to request competent authority assistance. These treaty deadlines can and do differ from domestic statutes of limitations, and taxpayers must take protective actions to keep recourse to competent authority open. The fact that the domestic statute of limitations may still be open for transfer pricing assessments in one or both of the affected countries is not determinative of the availability of competent authority assistance.

We strongly recommend that taxpayers that are either subject to a foreign tax audit, or that have a reasonable expectation that they may be subject to a foreign tax audit, review the relevant treaty timelines and take all necessary protective measures. Taxpayers do not need to wait until the conclusion of a transfer pricing audit to take such measures.

Failure to notify the IRS (or foreign tax authority) within the specified time frames will likely preclude the taxpayer from seeking competent authority relief from double taxation, and may also give rise to issues regarding the creditability of foreign taxes. *See Procter & Gamble Co. v. US*, (S.D. Ohio, Case No. 1:08-cv-00608, defendant's motion for summary judgment granted 7/6/10).

The table below summarizes the notification/action requirements and applicable time limitations for requesting competent authority assistance between the United States and all of its current treaty partners. Many treaties require notification to the tax authority that did not propose the adjustment within a certain number of years of the taxpayer's tax year end or the filing of a tax return (Canada, Finland, Jamaica, Mexico, Netherlands, and Turkey), Please note that the statute of limitations for a tax adjustment may extend past the due date for notification under the US-Mexico tax treaty. Consequently, we strongly advise taxpayers to file notifications with the IRS APMA program at the onset of any Mexican tax examination. In addition to the original notification, the IRS requires annual notification updates. The recently issued updates to the IRS competent authority procedures – Rev. Proc. 2015-40 – changed the due date for such updates beginning in 2016. The new due date for notification updates is the date on which the taxpayer timely files a tax return for that taxable year.

Taxpayers should consult with their tax advisors to evaluate the relevant provisions of the applicable treaty and their specific application to the taxpayer's facts and circumstances.

US Treaty Partner	Notification/Action Deadline per Treaty
Australia	The case must be presented within three years from the first notification of the tax authority action giving rise to taxation not in accordance with the provisions of the treaty.
Austria	No deadline.
Bangladesh	No deadline.
Barbados	No deadline.
Belgium	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Bulgaria	No deadline.

US Treaty Partner	Notification/Action Deadline per Treaty
Canada	The competent authority of the country that did not propose the adjustment must receive notification that such a case exists within six years from the end of the taxable year to which the case relates.
China	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Cyprus	No deadline.
Czech Republic	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Denmark	No deadline.
Egypt	No deadline.
Estonia	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Finland	The competent authority of the country that did not propose the adjustment must receive notification that such a case exists within six years from the end of the taxable year to which the case relates.
France	The case must be presented within three years of the notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Germany	The case must be presented within four years from the notification of the assessment giving rise to double taxation or to taxation not in accordance with the provisions of the treaty.
Greece	No deadline.
Hungary	No deadline.
Iceland	No deadline.
India	The case must be presented within three years of the date of receipt of notice of the action that gives rise to taxation not in accordance with the treaty.
Indonesia	The case must be presented within three years of the first notification of the action giving rise to taxation not in accordance with the provisions of the treaty. When a combination of decisions or actions taken in both countries results in taxation not in accordance with the provisions of the treaty, the three-year period begins to run only from the first notification of the most recent action or decision.
Ireland	No deadline.
Israel	No deadline.
Italy	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Jamaica	No deadline, except that the taxpayer or the competent authority of the United States must give notice within the time limits established by the domestic law of Jamaica to the competent authority of Jamaica that there may be a claim for tax adjustment.

US Treaty Partner	Notification/Action Deadline per Treaty
Japan	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Kazakhstan	No deadline.
Korea	No deadline.
Latvia	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Lithuania	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Luxembourg	No deadline.
Malta	No deadline.
Mexico	The competent authority of the country that did not propose the adjustment must receive notification that such a case exists within four and a half years from the due date or the date of filing of the return in that country, whichever is later.
Morocco	No deadline.
Netherlands	The competent authority of the country that did not propose the adjustment must receive notification that such a case exists within six years from the end of the taxable year to which the case relates.
New Zealand	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Norway	No deadline.
Pakistan	No deadline.
Philippines	No deadline.
Poland	No deadline.
Portugal	The case must be presented within five years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Romania	No deadline.
Russia	No deadline.
Slovakia	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Slovenia	The case must be presented within five years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
South Africa	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty (or in the case of tax collected at source, within three years from the date of collection).
Spain	The case must be presented within five years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.

US Treaty Partner	Notification/Action Deadline per Treaty
Sri Lanka	No deadline.
Sweden	No deadline.
Switzerland	No deadline.
Thailand	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.
Trinidad and Tobago	No deadline.
Tunisia	No deadline.
Turkey	The competent authority of the country that did not propose the adjustment must receive notification that such a case exists within five years from the end of the taxable year to which the case relates.
Ukraine	No deadline.
United Kingdom	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty or, if later, within six years from the end of the taxable year or chargeable period in respect of which that taxation is imposed or proposed.
Venezuela	No deadline; however, the statute of limitations must be "interrupted in accordance with the steps designated by domestic laws."

— Kerwin Chung (Washington, DC)
Principal
Deloitte Tax LLP
kechung@deloitte.com

Darrin Litsky (New York)
Director
Deloitte Tax LLP
dlitsky@deloitte.com

Kirsti Longley (Washington, DC)
Director
Deloitte Tax LLP
kilongley@deloitte.com

Joseph Tobin (Washington, DC)
Senior Manager
Deloitte Tax LLP
jtobin@deloitte.com

South Africa to Implement country-by-country reporting requirement

The South Africa Revenue Service (SARS) has announced that it will implement country-by-country (CbC) reporting in line with the OECD base erosion and profit shifting (BEPS) initiative (action 13), effective 1 January 2016.

The objective of CbC reporting is to provide the tax authorities in the jurisdiction of the ultimate parent company with an overview of the aggregate tax position of a multinational enterprise (MNE), and the allocation of revenue across the jurisdictions in which the MNE operates. South African-headquartered MNEs will be required to submit the CbC report to the SARS, which will share the report (as well as the master file) with relevant tax authorities through the exchange of information process.

The CbC report is structured to provide insight into the group's places of economic activity through the number of people it employs and its functional activity, so that the authorities can map economic activity and substance to reported revenue and tax payments. The CbC report must contain the following information for each entity within a group:

- Details of each entity and the jurisdiction in which that entity is tax resident;
- Profitability, taxes payable, tax accruals, stated capital, accumulated earnings, number of employees, and details of noncash tangible assets, which will allow some broad economic ratios to be calculated and compared; and
- Details of the main functional nature of each entity (for example, R&D, manufacturing, group finance, holding company) which will allow mapping of functionality to revenues, number of employees, and tax contribution.

Fundamentally, the CbC report is intended to assist the tax authorities in carrying out a transfer pricing risk assessment. For example, a CbC report that shows an intellectual property holding company situated in a low-tax jurisdiction with high revenue, low tax, and a small number of employees likely would increase the level of transfer pricing risk. This does not necessarily mean that there would be a transfer pricing issue, but it does highlight the importance of ensuring that transfer pricing policies and documentation are robust and defensible.

The CbC report is the third tier of the recommended documentation proposals from the OECD, with the other two tiers being a group master file and local country files. The intent is that all of these documents work together to provide tax authorities with sufficient information to make an informed decision on the level of transfer pricing risk, as well as the basis for an audit and possible transfer pricing adjustments. The CbC report will function as the risk assessment tool, while the master file will function as the basis for a transfer pricing audit.

CbC reporting

South African MNEs with annual group consolidated turnover exceeding ZAR 11.5 billion in the 2015 financial year will be required to prepare the CbC report for financial years starting on or after 1 January 2016. The reporting deadline is 12 months from the end of the financial reporting year; therefore, the first reporting period for a South African MNE with a 31 December year-end will be 1 January-31 December 2016, with the report due to the SARS by 31 December 2017.

CbC reporting will not be applicable to South African intermediary holding companies.

Although SARS previously indicated that it likely would require more information in its CbC reporting template than what is provided in the OECD's action 13 report, SARS now has confirmed that the template issued by the OECD should be used.

Preparing for CbC reporting and practical considerations

A South African MNE that is likely to meet the threshold for CbC reporting should be considering whether its systems are adequate to provide the information that will be required and, if not, what system upgrades will be required. In addition, it will be important to ensure that an audit trail supporting the source of the data is maintained and that the group's transfer pricing documentation is current and aligned with the CbC report. Because CbC reporting will apply effective 1 January 2016, there is a limited period during which an MNC can review its existing transfer pricing policies and structures to ensure that what is disclosed in the CbC reporting is defensible.

CbC reporting will expand the compliance requirements for MNEs; they will need to assess their current systems and processes (tax, finance, and information technology) to determine the most efficient and effective manner in which to extract the required financial information across the group.

— Karen Miller (Cape Town)
Associate Director
Deloitte South Africa
karmiller@deloitte.co.za

France takes steps toward implementation of country-by-country reporting

The French National Assembly on November 12 approved an amendment to the draft Finance Bill for 2016 implementing the country-by-country reporting requirement in France, with the government's full support. The measure must be approved by the full assembly before it can enter into force. That vote is expected in December.

The precise list of data to be included in the French country-by-country report would be defined by an administrative decree, but should include information about a multinational enterprise's turnover, before-tax profits, and number of employees in the countries where the group is located. The administrative decree is expected to implement the recommendations of the OECD's final report on Action 13 of the base erosion ad profit shifting (BEPS) project.

According to this amendment, the companies within the scope of the country-by-country reporting requirement would include:

- Companies with consolidated accounts;
- Companies that control, directly or indirectly, subsidiaries located abroad, or that have branches located abroad;
- Companies with annual consolidated group revenue equal to or in excess of EUR 750 million; and
- Companies not owned by another French entity already within the scope of this measure, or by a foreign entity within the scope of a similar provision under its local legislation.

The annual country- by-country report would have to be filed with the French tax authorities within 12 months after the fiscal year-end.

The country-by-country report would be exchanged automatically between concerned tax administrations in accordance with applicable tax treaties and/or EU regulations under the condition of reciprocity, but should remain confidential, because two amendments that called for public release of the information were rejected. The French finance minister indicated that he would like to implement "all BEPS but only BEPS."

Failure to comply with this measure would trigger penalties that would not exceed €100,000.

The new rule would be applicable for fiscal years that start on or after January 1, 2016.

— Grégoire de Vogüé (Paris)
Partner
Taj
gdevogue@taj.fr

Jean-Luc Trucchi (Paris)
Partner
Taj
jtrucchi@taj.fr

Eric Lesprit (Paris)
Partner
Taj
elesprit@taj.fr

Marie-Charlotte Mahieu author (city)
Director
Taj
mmahieu@taj.fr

Aymeric Nouaille-Degorce (Paris)
Partner
Taj
aynouailledegorce@taj.fr

Deyan Mollov (Paris)
Director
Taj
dmollov@taj.fr

Julien Pellefigue (Paris)
Partner
Taj
jpellefigue@taj.fr

US court rules on reallocation of losses on bad Chinese debt

The US District Court for the District of Columbia recently upheld the IRS's use of section 482 of the Internal Revenue Code to deny deductions and losses for nonperforming Chinese bank loans held by the taxpayer. In doing so, the court upheld the IRS's view of section 482 by upholding the IRS's ability to use section 482 to make adjustments to the pricing of transactions that occurred between two foreign entities prior to any transaction taking place between either foreign entity with the US taxpayer subject to an income tax adjustment. The issue came before the court on motions for summary judgment by both parties on the section 482 matter.

The nonperforming loans at issue in *Austin Investment v. United States* (2015 BL 381288, D.D.C., No. 1:11-cv-02300, November 19, 2015) were part of a package of distressed debt that had been sold by the Bank of China (a Chinese state-owned "good bank," a term used in the decision) to China Orient (a Chinese state-owned "bad bank" (also the court's term) created by the Chinese government to hold a nonperforming loan portfolio) as part of a Chinese government plan to isolate all bad debt from its four "good banks" and transfer all such distressed debt to four "bad banks." When the distressed debt was transferred from a good bank to a bad bank under the government plan, it was transferred at face value rather than at its fair market value. Thus, with respect to the portfolio of loans at issue in this case, the bad bank had a basis that reflected the face value of the loan package ($210 million) rather than the fair market value of the loans.

When Austin Investment purchased a 23 percent share (later reduced to a 19.24 percent share) of the distressed debt package from the bad bank, it paid the standard discounted price for such debt, which was approximately 10 percent of the face value of its percentage share of the loans in question (that is, 10% x 23% x $210 million, which was approximately $4 million). The IRS maintained that Austin Investment should only be allowed deductions and losses for US income tax purposes based on the $4 million purchase price it paid for the distressed debt rather than the $43 million face value of its percentage share of the distressed debt package. Austin Investment maintained that it was entitled to a carryover basis of $43 million in its percentage share of the loan package, because that was a pro rata amount of what the bad bank had paid for the loans when it purchased them from the good bank. The IRS rejected this argument because it maintained that it had authority under section 482 to adjust the pricing of the transaction between the good bank and the bad bank to ensure that the bad bank's basis in the asset reflected the true arm's length price of the asset rather than its face value.

The taxpayer also urged the court to reject the IRS's argument with respect to its authority to use section 482 to adjust pricing between two foreign entities on the basis of a prior case that considered a similar fact pattern and reached the opposite conclusion. In *Southgate Master Fund v. United States*, 651 F. Supp. 2d 596 (N.D. Tex. 2009), aff'd 659 F.3d 466 (5th Cir. 2011), the court concluded that the IRS could not rely on section 482 to disallow the taxpayer's losses because: (1) the court was not convinced that section 482 was applicable to two foreign organizations; and (2) it was not apparent to the court that the two Chinese entities were commonly controlled[1] despite overarching ownership by the Chinese government.

The *Austin Investment* court rejected the taxpayer's arguments based on *Southgate* for two reasons. First, the *Austin Investment* court found that the *Southgate* discussion of section 482 was dicta, because the *Southgate* court had decided the cased based on its finding that the partnership at issue was a sham; thus, it did not need to reach the section 482 issue and its discussion of section 482 was gratuitous. Second, the court did not find the *Southgate* court's discussion of section 482 persuasive because the court found that (1) the statutory language in section 482[2] clearly allowed for the possibility that the IRS could apply section 482 to two foreign organizations; and (2) it did not matter whether the two entities at issue were commonly controlled because the IRS can use section 482 if it can show that two entities are commonly controlled *or* commonly owned (citing prior case law on this issue), and it was clear that the two entities in this case (the good bank and the bad bank) were commonly owned by the Chinese government.[3]

The taxpayer urged the court to reject the IRS's argument with respect to its authority to use section 482 by arguing that the "act of state doctrine" precluded the IRS from applying section 482 to the transactions at issue in this case. The taxpayer maintained that because Chinese

[1] The taxpayer argued that in order for the IRS to apply section 482, the IRS must show that there was both common control *and* common ownership between the two entities at stake in the transaction under review by the IRS.
[2] Specifically, the court cited the following language: "In any case of two or more organizations, trades, or businesses (whether or not incorporated, *whether or not organized in the United States*, and whether or not affiliated…." 26 IRC § 482 (emphasis added).
[3] The taxpayer did not dispute that there was common ownership, that is, that the Chinese government owned both the good bank and the bad bank.

law mandated a certain price for the transfer of the nonperforming loan portfolio from the good bank to the bad bank (i.e., at face value), the IRS must accept the price set by Chinese law in applying US tax laws. To do otherwise, the taxpayer argued, would result in the IRS violating the act of state doctrine. The court disagreed because it maintained that the act of state doctrine merely directed US courts to refrain from deciding a case when the outcome of the case depends on determining the legality or illegality (under US, foreign, or international law) of official action by a foreign sovereign performed within its own territory. In this case, the IRS did not seek a declaration that any action of the Chinese government was illegal in any way; rather, the IRS simply sought application of US tax laws to the facts presented by the transactions at issue in this case.

Having found that the IRS was authorized to apply section 482 to the transaction between the good bank and the bad bank, the court went on to consider whether the IRS had been "arbitrary and capricious" in its application of section 482. The IRS had maintained that the arm's length price of the sale of the distressed debt from the good bank to the bad bank was not the $210 million face value of the loans, but rather was $21 million, the discounted price at which such a package of debt could be obtained on the open market. The court found that, under the "arbitrary and capricious" standard, the taxpayer has the burden of proof to show that the IRS's finding was "arbitrary and capricious" and that the taxpayer had failed to meet this burden because the taxpayer had not produced any evidence that the $210 million face value amount was in fact an arm's length amount, and had not produced any evidence that the $21 million amount was not arm's length. Additionally, the court found that the only evidence pertaining to the issue (a valuation report) demonstrated that packages of distressed Chinese government loans were generally selling for about 10 percent of their face value, so the 10 percent of face value paid by Austin Investment for its portion of the package of distressed debt was approximately what could have been obtained for the package on the open market.

Conclusion

The taxpayer in the *Austin Investment* case made two arguments that are not often raised in transfer pricing cases – that section 482 does not apply to transactions between two foreign entities, and that the act of state doctrine precludes the IRS from using section 482 to reallocate tax items – but the court rejected both of the taxpayer's arguments.

— Kerwin Chung (Washington, DC)
Principal
Deloitte Tax LLP
kechung@deloitte.com

Joseph Tobin (Washington, DC)
Senior Manager
Deloitte Tax LLP
jtobin@deloitte.com

India issues rules for application of range and multiple-year data

India's Central Board of Direct Taxes (CBDT) on October 19 issued a notification setting out final rules on the use of arm's length ranges and multiple-year data to determine arm's length prices for related-party transactions.

The final rules provide a three-step process for comparability analyses and the determination of an arm's length price for international transactions or specified domestic transactions (related-party transactions) as follows:

- **Selection of comparables:** The comparables are to be selected by applying quantitative and qualitative filters on current-year data (if available) or immediately preceding financial-year data. However, for the comparable uncontrolled price (CUP) method, the profit split method, and the "other method," only current-year data will be used for the selection of comparables.
- **Data to be used for determination of arm's length price:** Once the comparables are selected, the weighted average of the three-year data or fewer (whichever is available) would be used to determine the data values in comparables set for determining the arm's length price. Further, the multiple-year data concept cannot be applied to CUP, the profit split method, and the "other method."
- **Applicability of range:** If there are six or more comparables, and the method used is the CUP, the cost plus method (CPM), the resale price method (RPM), or the transactional net margin method (TNMM), the arm's length price will be determined based on the 35th to 65th percentile of the data values in the comparables set (as computed in the notification). However, if there are fewer than six comparables, or the method used is the profit split method or the "other method," the arithmetic mean will be applied, along with +/-3 percent variation for determining the arm's length price.

The notification also prescribes that if the current-year data related to the relevant assessment year under consideration becomes available during the course of assessment proceedings, that data may be used, irrespective of the fact that the same was not available at the time the income tax return for the relevant assessment year was filed.

Summary of the Rules

Applicability: The notification provides that the rules will apply for determining the arm's length price in all related-party transactions entered into on or after April 1, 2014.

Selection of comparables and use of multiple-year data: The notification provides that for purpose of analyzing the comparability of an uncontrolled transaction with the related-party transaction, the data pertaining to the current year in which the related-party transaction has taken place should be considered.

However, in cases where the RPM, the CPM, or the TNMM is selected as the most appropriate method and the current year data is not available at the time of furnishing the return of income, the data pertaining to the immediately preceding financial year (to the current year) should be taken into consideration for analyzing the comparability of an uncontrolled transaction.

Consequently, if more than one price is determined (that is, more than one comparable is selected) by using any of the most appropriate methods, the data values of the comparable set will be determined as follows.

If the RPM, CPM and TNMM are used, and the current-year data of the comparable is available and if the comparable has also undertaken similar uncontrolled transactions in the immediately previous two financial years, the most appropriate method will be applied in similar manner to the preceding two financial years, and the weighted average data values of the three years will be considered.

In case of RPM, CPM and TNMM, where the data for financial year preceding to the current year is used and the comparable has also undertaken the same or similar uncontrolled transaction in the year immediately preceding year (to such financial year), then the weighted average data value of those two years will be considered.

When the CUP, the profit split method, or the "other method" is applied, the data for only current year will be used to determine the data values of the comparable set.

The data values so determined for comparables will be placed in an ascending order to determine the arm's length price (data set).

Range of arm's length price: The arm's length price will be determined on the basis of data set constructed as follows:

Situation 1 –

- In cases where CUP or RPM or CPM or TNMM is used; and
- The data set used comprises six or more comparables

The arm's length price will be the prices falling within the 35th and the 65th percentile of the above data set. Accordingly, if the price at which the related-party transaction is entered into by the taxpayer falls within the range of the 35th to the 65th percentile, that transaction price will be regarded as the arm's length price. However, if the transaction price does not fall within the range of 35th to 65th percentile, the median of the dataset shall be regarded as ALP of the related party transaction.

Situation 2 –

- In cases where the profit split method or the "other method" is used; or
- Where the number of comparables in the data set for CUP, RPM, CPM or TNMM is fewer than six

The arm's length price will be the arithmetic mean of all the values included in the data set. Additionally, the variation of +/- 3 percent (as per the former rules) will be allowed in such cases for determining the arm's length price.

Determination of ALP at the time of assessment proceedings: The notification provides that at the time of assessment proceedings, the comparables selection may be modified in case of RPM, CPM and TNMM as follows:

- If a comparable selected on the basis of preceding financial year data does not satisfy comparability parameters based on the current year data (available at the time of assessment proceedings), it will be deleted; and

- If any new comparable is available that satisfies the comparability parameters, it will be included in the comparable set for determining the arm's length price.

Determination of the percentiles in range: The range and the median to be used for determining the ALP is not just a simple 35 percent or 65 percent of the data values in the data set. The notification provides the methodology for determining these range values as follows:

- Count the number of entries in the data set and determine the 35 percent and 65 percent of such count. The value placed in the data set at such 35 percent and 65 percent position is taken as 35th percentile and 65th percentile. For example, if the total number of comparables in the set is seven, then the 35 percent of 7 is 2.45 and 65 percent is 4.55. So the 35th percentile would be the value of comparable at 3rd place in the data set and 65th percentile would be the value of comparable placed at 5th position in the data set. Therefore, effectively the allowable range would be the margin of 3rd and 5th comparable in this example.
- The notification further provides that if the 35 percent or 65 percent of the count of entries in the comparable set is a whole value; for example, in a set comprising of 20 comparables, 35 percent and 65 percent of the comparable set is 7 and 13. In such case, the 35th percentile would be the arithmetic mean of the values of comparables at 7th and 8th position in the data set. Similarly, the 65th percentile would be the arithmetic mean of the values of comparables at 13th and 14th position in the data set.

The values of median would also be determined in the same manner.

Conclusion

The CBDT has provided a method for comparability analysis that differs from the globally followed best practices. Similarly, the range of 35th to 65th percentile, as well as the computation mechanism for such range, is not followed anywhere else in the world. Further, the range depends on the position of comparables at 35th and 65th percentile position.

There is a possibility that in some cases the range may allow only a very restrictive range of arm's length prices, which may be even lesser than the erstwhile law of arithmetic mean with +/-3percent variation. Further, the CBDT has not provided the logic or basis for selecting six comparables as the threshold for the number of comparables to apply the range concept. Additionally, allowance of fresh search at the time of assessment proceedings would continue to create uncertainty for the taxpayers regarding the final arm's length price that may be used by the tax authorities.

Even though the objective of the notification was to frame rules for determination of arm's length prices in line with international best practices and to reduce the number of transfer pricing disputes and thereby provide certainty to taxpayers, it will be open to debate whether the new rules will fulfill these objectives.

— Mudigonda Vishweshwar (Bangalore)
Partner
Deloitte India
mvishweshwar@deloitte.com

Sanjay Kumar (Delhi)
Senior Advisor
Deloitte India
kumarsanjay@deloitte.com

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.