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Japan releases revised transfer pricing administrative guidelines

Japan's National Tax Agency (NTA) recently released a revised version of the Commissioner's Directive on the Operation of Transfer Pricing, known as the Administrative Guidelines.

The Administrative Guidelines do not have the force of law in Japan and are not binding on Japanese taxpayers. They are intended to encourage a consistent application of Japan's transfer pricing rules at the various levels of the tax authorities. Therefore, the Administrative Guidelines are an important source of guidance for how the Japanese authorities are likely to interpret Japan's transfer pricing rules. A discussion draft of the amended Administrative Guidelines was released on November 10, 2017, with comments submitted to the NTA until December 10, 2017. The final Administrative Guidelines were released on February 23, 2018.

The key changes for foreign multinationals operating in Japan can be grouped into two categories: (1) changes to the advance pricing arrangement (APA) landscape in Japan; and (2) revisions concerning intragroup service provision. This article summarizes the most important aspects of each group of changes, as well as possible challenges for taxpayers resulting from the changes.

Changes to the APA landscape in Japan

Clarification on the relationship between audit and APA: Historically, Japan has had no clear guidance on the relationship between tax audits and APAs, other than a statement that an APA application does not preclude the tax authorities from conducting an audit, and that information provided during APA procedures cannot be used in tax audits without approval from the taxpayer.

In practice, however, there was an understanding among taxpayers and practitioners that, when a taxpayer requests an APA, the APA covered years would not be subject to tax audits, and that this would include any years covered by a retroactive application of the APA (an APA rollback).

The amendments to the Administrative Guidelines clarify that:

- Even when a taxpayer requests a rollback in an APA application, a tax examiner is not barred from carrying out an audit of the rollback years.
- When an APA is being discussed or agreed to, tax filings (limited to those relating to transfer prices covered by the APA), will not be subject to tax audits for the APA years.

Based on the explanation provided by the Japanese tax authorities, the amendments are intended to confirm that APA rollback years may still be audited, even after an APA request has been filed, and the tax authorities' view that this has always been the case. Based on this, it would be prudent to consider possible consequences of the changes for APA rollback years, as follows:

- If APA rollback years are subject to an audit that has commenced, the audit will continue covering the rollback years, and the APA review may be deferred. Once the audit is completed, the APA review for the covered years would recommence.
- If an audit is commenced on APA rollback years after the filing of an APA application, the audit for APA rollback years will commence and the APA review for the covered years may be deferred. Once the audit is completed, the APA review for the covered years would recommence.

As a general comment, we would expect it to take more time to complete the APA process when APA rollback years are being audited, or subject to possible future audits.

Deadlines for responding to information document requests: Another important change is the introduction of a deadline for responding to information document requests (IDRs) from the Japanese tax authorities during their review of an APA application. New Article 6-11-(3) of the Administrative Guidelines provides that an IDR must be answered before the deadline set by the APA review officer, which shall not exceed 45 days from the IDR date.

Previously, no specific deadline was provided for responding to such requests, and the timing of a response was at the discretion of the tax officer requesting the information. The new deadline is consistent with the timing for large companies to submit their local file after a request, indicating that the tax authorities view 45 days as a reasonable amount of time for taxpayers to respond to a request for information, and seemingly encouraging taxpayers to be well prepared for an APA application.

If the taxpayer does not respond to an IDR within the prescribed time frame, the tax authorities would classify the application as a case where concluding an APA or commencing review of the APA application is not appropriate, resulting in either a withdrawal of the APA application by the taxpayer, or a denial of the APA application by the Japanese tax authorities. The Japanese tax authorities' APA review process generally involves significant scrutiny of the APA application, including issuing a substantial number of IDRs, and the new timing requirement may pose a compliance challenge for multinationals applying for Japanese APAs.

Importance of prefiling meeting: The revised Administrative Guidelines suggest that the Japanese authorities place even greater importance on the prefiling meeting prior to filing an APA application. The newly added Article 6-2-(1)

states that the Japanese tax authorities should direct taxpayers to hold a prefiling meeting prior to filing of APA applications. Although prefiling meetings are not mandatory under law, prefiling meetings are becoming more important in Japan. A prefiling meeting presents an opportunity for the Japanese tax authorities to state their comments and guidance to taxpayers as to what they would prefer to see in the APA application.

The changes to the Administrative Guidelines are consistent with comments in the NTA's Transfer Pricing Guide Book for Taxpayers issued in 2017, further demonstrating the importance the tax authorities place on the prefiling meeting.

While it is within a taxpayer's right not to hold a prefiling meeting, and there may be reasons why a taxpayer chooses not to do so, careful consideration of this issue would be warranted, given the risk of prejudicing the APA negotiation process.

Special conditions for suspension of APA review: The Administrative Guidelines were amended to allow the suspension of a review of bilateral APA applications involving mutual agreement procedures. Recently, the Japanese tax authorities have seen an increasing number of bilateral APA applications involving countries whose competent authorities have limited APA experience (for example, non-OECD countries) leading to significant delays in concluding APAs or accepting APA applications. This amendment allows the Japanese authorities to clear their APA inventory of cases when there is a long delay. Based on the changes, if the bilateral APA application is not received/accepted, or is unlikely to be received/accepted, by the counterparty competent authorities three years from the day after the filing deadline, the APA must be withdrawn or converted to a unilateral APA application. For APAs filed before the amended Administrative Guidelines were published, the three-year period begins on the date of the amended Administrative Guidelines, rather than the standard timing.

Revisions regarding intragroup service provision

Low-value-adding services: Revisions were also made to the calculation approach for low-value-adding services in the Administrative Guidelines. These revisions are consistent with the 2015 BEPS final report on low-value-adding services, which provides a simplified approach for pricing such intragroup services. Under the new provision, certain intragroup service transactions will be deemed to be at arm's length if the service is priced on a cost-plus five percent basis. This may be selected as an alternative to the conventional calculation methodology.

In order to apply the simplified calculation method, all of the following requirements must be met:

- The provision of the service must be supportive in nature, and have no direct relationship to the group's core business activities.
- Intangible assets must not be used in the provision of the service. This includes intangibles owned by the taxpayer, foreign related parties, or licensed from third parties.
- The service-providing entity must not assume, manage, or create material risks in relation to the service.
- The contents of the service do not fall under any of the following functions: (i) research and development, (ii) manufacturing, distribution, purchase of raw materials, logistics, or marketing, (iii) finance, insurance or reinsurance, or (iv) mining, exploration, or formulation.
- No identical service is provided to or by third parties.
- When all requirements above are met, a service fee is calculated based on the total cost incurred by the service provider (both direct and indirect) relating to the particular service recipient. A reasonable allocation methodology should be used. After calculating the costs, a five percent markup is added.
- Documentation on the service transaction must be prepared/obtained and maintained.

The previous version of the Administrative Guidelines stated that the service cost itself (i.e., cost-based pricing without markups) could be used in the determination of an arm's length price for certain services that are auxiliary to a taxpayer's core business. These provisions remain in the amended Administrative Guidelines, alongside the simplified approach described above. The Administrative Guidelines simply provide that tax examiners should "consider" either the five percent markup on cost approach or the cost-based approach for certain service provisions. Additional clarification is required on the interaction between the two approaches, and when either one is considered appropriate.

Elaboration on shareholder activities: The amended Administrative Guidelines provide comments on shareholder activities that would not be considered services to foreign related parties (and thus would not justify a charge to the foreign related parties). The guidance is generally consistent with the OECD transfer pricing guidelines. However, there are minor differences. For example, the Administrative Guidelines further clarify that the cost of preparation of records relating to the CbC report by a parent company falls into shareholder activities costs (as well as costs of other activities relating to compliance of the parent company with relevant tax laws), whereas the OECD transfer pricing guidelines only state that costs relating to compliance by the parent company with relevant tax laws are examples of costs associated with shareholder activities.

Comments

The Transfer Pricing Administrative Guidelines are an important source of guidance for how the Japanese authorities are likely to interpret the transfer pricing rules in Japan; in that context, changes to the guidelines are significant.

For taxpayers considering an APA, it would be prudent to consider the changes described in this article at an early stage. This includes considering any potential impact on rollback years, timing of the APA process, being in a position to respond to information requests in a timely manner, and the importance of the decision whether to hold a prefiling meeting.

Taxpayers providing or receiving certain low-value-adding intragroup services now have an additional, simplified method of calculating service fees. While the method is generally consistent with the OECD view, if the new method is to be used, taxpayers would be well advised to consider the consequences in the counterparty jurisdiction. For affected taxpayers, it would also be prudent to monitor additional guidance from the authorities clarifying the interaction of the simplified approach with the existing cost-based pricing method.

— Jun Sawada (Tokyo)
Partner
Deloitte Japan
junsawada@tohmatsu.co.jp

Timothy O'Brien (Tokyo)
Partner
Deloitte Japan
timothy.obrien@tohmatsu.co.jp

Samuel Gordon (Tokyo)
Partner
Deloitte Japan
samuel.gordon@tohmatsu.co.jp

India delays due date for filing country-by-country reports by Indian constituent entities of foreign MNEs

India has deferred the due date for filing the country-by-country (CbC) report in India by Indian constituent entities of foreign-headquartered multinational entity (MNE) groups from March 31, 2018, to a future yet-to-be determined date.

The Indian CbC regulations prescribe secondary filing of the CbC report in India by an Indian constituent entity of a foreign MNE group under certain specified circumstances. These specified circumstances are provided in Section 286(4) of the Income Tax Act, 1961, as follows:

- When there is no obligation to file the CbC report in the parent entity's jurisdiction;
- When the parent entity is resident of a country or territory with which India does not have an agreement for the exchange of CbC reports; or
- When there has been a systemic failure in the country or territory in which the parent entity is resident, and the failure has been notified to the constituent entity.

Thus, a foreign MNE group's CbC report is required to be filed in India by the Indian constituent entity if any of the above conditions are satisfied.

The Finance Act, 2018 has now specified that the due date for filing the CbC report in India by an Indian constituent entity of a foreign MNE group under certain specified circumstances will be "within the period as may be prescribed." This amendment was confirmed by a clarification provided by the Indian government in a March 23 press release, which states that the due date of March 31, 2018, would not be applicable to the filing of the CbC report in India by an Indian constituent entity of a foreign MNE group, and that the new due date will be prescribed.

URL: https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/696/Press-Release-CBDT-issues-clarification-regarding-requirement-26-3-2018.pdf

Accordingly, the secondary filing in India of the CbC report applicable to Indian constituent entities of a foreign MNE group under the specified circumstances is not triggered until the relevant due date is prescribed in the Indian Tax Rules.

— Anis Chakravarty (Mumbai)
Partner
Deloitte India
anchakravarty@deloitte.com

Irish Revenue release guidelines on low-value intragroup services

The Irish Revenue issued guidelines in March on a simplified approach to low-value intragroup services, indicating that they are prepared to accept a 5 percent mark-up of the relevant costs without requiring a formal benchmarking study. The guidelines also set out the documentation requirements for taxpayers to avail themselves of this simplified approach.
URL: https://www.revenue.ie/en/tax-professionals/ebrief/2018/no-0372018.aspx

Details

The guidelines set out what services constitute low-value intragroup services for purposes of the simplified regime. These are services that exhibit the following features:

- The services are of an administrative/routine nature, often consisting of back-office support services;
- The services are supportive in nature and not part of the multinational group's core business;
- The services do not use or create unique and valuable intangible assets; and
- The services do not involve significant risk for the service provider.

The guidelines state that there is no definitive list of services that can be considered to be low-value-adding in nature. The facts and circumstances must be considered on a case-by-case basis.

The guidelines also refer to Chapter VII of the 2010 OECD transfer pricing guidelines, which provide further guidance regarding intragroup services and the key considerations in analyzing intragroup services for transfer pricing purposes:

- Whether intragroup services have been rendered; and
- What the charge for such intragroup services should be in accordance with the arm's length principle.

In applying the benefit test to low-value intragroup services, Irish Revenue are prepared to accept the taxpayer's evidence of benefit by category of service, rather than requiring that the taxpayer specify individual activities performed that give rise to the costs charged. When no benefit is provided, Irish Revenue will not accept the charge as a deductible cost for corporation tax purposes in the hands of the recipient Irish company.

Irish Revenue consider the cost-based method as the most appropriate transfer pricing method once the cost base has been determined. A 5 percent mark-up on the relevant costs is acceptable without the need for a formal benchmarking study.

Certain supporting documentation is required that must clearly set out what services are provided or received when the simplified approach is adopted. The following information must be included in the documentation:

- A description of the low-value intragroup services provided/received;
- The identity of the service's recipient/provider;
- An explanation of why the services fall under the simplified approach;
- The rationale for the provision/receipt of such services;
- A description of the benefits of each category of services;

- Confirmation of the mark-up applied;
- Written contracts for the provision of the services and relevant amendments to those contracts;
- Calculation of the fee showing the calculation of the cost base, the application of relevant allocation key(s), and the mark-up applied;
- Confirmation that shareholder costs and duplicate costs are excluded from the cost base; and
- Confirmation that no mark-up has been applied to passthrough costs.

Irish Revenue also refer to the EU Joint Transfer Pricing Forum work on low-value-adding intragroup services, and note that the guidelines published by the EUJTPF represent good practices consistent with the guidance notes issued.

Comments

The publication of the guidance notes by Irish Revenue provides taxpayers with a level of support in terms of how to deal practically with related-party transactions that are routine in nature and fall within the ambit of the guidance. Many taxpayers have applied such an approach for years.

Interestingly, the guidance notes are drafted with reference to the 2010 version of the OECD transfer pricing guidelines, because Ireland's domestic transfer pricing laws still align with the 2010 guidelines. Action 10 of the OECD's base erosion and profit shifting (BEPS) project provided a more up-to-date framework for dealing with low-value intragroup services, which is included in the updated Chapter VII of the 2017 OECD transfer pricing guidelines. The updated Chapter VII does provide examples of services that would not constitute low-value intragroup services in paragraph 7.47. In addition, examples of services that may constitute low-value intragroup services are outlined in paragraph 7.49.

While the 2017 OECD transfer pricing guidelines have not been formally adopted in Ireland yet, the new provisions contained in Chapter VII should still be read in conjunction with the guidance notes issued by Irish Revenue when formulating a transfer pricing policy for low-value intragroup services.

— Gerard Feeney (Dublin)
Director
Deloitte Ireland
gfeeney@deloitte.ie

Singapore revises guidelines on mandatory transfer pricing documentation

In October 2017, Singapore approved legislation on mandatory transfer pricing documentation, and on 23 February 2018 it gazetted the Income Tax (Transfer Pricing Documentation) Rules 2018. Concurrently, the Inland Revenue Authority of Singapore (IRAS) issued revised transfer pricing guidelines, detailing the changes introduced in the new legislation and the rules.

Even though most of the requirements under the new legislation are not new (and in fact, many are already mandatory or required under the current transfer pricing guidelines), the introduction of the new legislation marks a distinct shift from the current, practice-based transfer pricing regime to a more formal, rule-based regime, whereby requirements are now codified in tax legislation and rules.

Most notably with regard to transfer pricing documentation, which is currently mandatory "as part of the record-keeping requirements for tax" (that is, under the general recordkeeping provisions of Section 67 of the Singapore Income Tax Act (SITA)) with certain exemptions provided under the current transfer pricing guidelines, mandatory documentation is now required under the newly legislated Section 34F of the SITA, and exemptions are also formally codified under the rules.

The following sections discuss the highlights of the new legislation, the rules, and the revised guidelines.

Mandatory transfer pricing documentation – requirement and exemptions

The new Section 34F introduced in the SITA requires the preparation and maintenance of contemporaneous and adequate transfer pricing documentation with effect from year of assessment (YA) 2019 (i.e., financial year ending 2018), and the revised transfer pricing guidelines refer to this as "transfer pricing documentation under Section 34F."

It is important to note that even before the enactment of Section 34F, mandatory documentation was already required under Section 67 of the SITA and the current transfer pricing guidelines. This has not changed and continues to apply to documentation required for YA 2018 (financial year ending 2017) and before. With the enactment of Section 34F, documentation prepared with effect from YA 2019 under the requirements of this new section is referred to as "documentation under Section 34F."

The documentation requirements under the new Section 34F are largely similar to those under the current requirements, namely, the requirement to prepare documentation (including the level and type of information to be documented) no later than the filing deadline for the tax return, the submission of documentation to the IRAS within 30 days of a request, the retention of documentation for five years. Those requirements are affirmed, but now are codified in the new legislation and the rules.

One notable difference is the introduction of an additional exemption from the documentation preparation requirement, based on a test of whether the entity's annual gross revenue (that is, income from a trade or business) exceeds SGD 10 million. The existing exemption thresholds remain, and this new exemption serves as an additional safe harbor to those existing thresholds.

The new exemption includes two conditions, and an entity qualifies for the exemption only if it meets both:

1. Annual gross revenue from the taxpayer's trade or business for the basis period concerned does not exceed SGD 10 million; and
2. The taxpayer was not required to prepare documentation under Section 34F for the immediate preceding year – YA 2020 would be the first year that this test will be applicable. However, if the entity breaches this test (for instance, it was required to prepare documentation for the immediate preceding year) but its annual gross revenue does not exceed SGD 10 million for the immediate two preceding years, the entity is considered to have met this test.

To determine if exemption from the documentation requirement is available, an entity would first need to assess if it meets the conditions of the new exemption. If it does, it does not need to prepare documentation.

If the entity does not meet the conditions of the new exemption, it would need to prepare documentation, but may avail itself of certain specific/transaction exemption thresholds. These are largely the same as the current exemption thresholds, though now specifically codified under the rules, and they are as follows:

- Related-party domestic transaction subject to same tax rate – transactions between related parties in Singapore (excluding related-party loans) where both parties are subject to the same Singapore tax rates, or exempt from Singapore tax.
- Related-party domestic loan – a loan provided between related parties in Singapore, and the lender is not in the business of borrowing and lending money.
- Related-party loan where the safe harbor interest margin is applied.
- Provision of support services qualifying as "routine" services to which a 5 percent cost mark-up is applied.
- Related-party transactions covered by an advance pricing arrangement (APA).
- Related-party transactions not exceeding the following values:

Type of Transaction	Value (SGD)
Purchase of goods	15 million
Sales of goods	15 million
Loan to related party	15 million
Loan from related party	15 million
Provision of service	1 million
Receipt of service	1 million
Grant of right to use property or lease	1 million

Type of Transaction	Value (SGD)
Receipt of right to use property or lease	1 million
Guarantee provided	1 million
Guarantee received	1 million
Any other transaction	1 million

The rules and guidelines by and large maintain the same level of information and the format required for documentation. However, the new guidelines (at paragraph 6.25) accept documentation in the format of an OECD-style master file or local file, as long as the required information is documented.

Penalties

Under the new Section 34F(8), failure to prepare the required documentation constitutes an offense, and the taxpayer is liable to a fine/penalty of up to SGD 10,000 per offense.

More specifically, a taxpayer may be liable to the fine for the following noncompliance:

- Failure to prepare or maintain documentation according to the requirements under the rules;
- Failure to prepare documentation by the tax return due date;
- Failure to retain the documentation for a period of five years;
- Failure to submit the documentation within 30 days of a written request by the IRAS; or
- Providing any documentation or information the taxpayer knows to be false or misleading.

This marks a significant increase in the penalty for not preparing documentation. Before the enactment of Section 34F, there was no specific penalty for failure to prepare documentation or to submit adequate documentation on time upon request. These previously may have been subject to the general offense penalty under Section 94(2) of the SITA, which involves a fine not exceeding SGD 1,000.

The new penalty regime will take effect from YA 2019.

Updating documentation

The current guidelines state that "[t]axpayers should update their TP documentation when there are material changes to the operating conditions that impact their functional analysis or transfer pricing analysis. In any case, IRAS encourages taxpayers to update their TP documentation at least once every three years."

In other words, the guidelines require a major update of the transfer pricing documentation every three years (unless there is a material change to the operating conditions of the taxpayer or industry), and encourages a review and simple update of the benchmarking results in the intervening two years.

This broad approach to updating documentation is retained with the enactment of Section 34F, but a formal framework (with detailed conditions) is now prescribed under the new rules.

The revised guidelines state that "taxpayers are to review and refresh their TP documentation annually. This will result in taxpayers having to prepare a TP documentation for each basis period," but that "to reduce taxpayers' compliance burden, IRAS allows taxpayers to use the TP documentation they have prepared previously to support the transfer price…if that past TP documentation is a qualifying past TP documentation."

A "qualifying past TP documentation" is a past documentation prepared in one or two preceding years (that is, documentation prepared in Year 1 can potentially be used for Years 2 and 3, whereas a major update/new documentation will be required for Year 4), provided that the following specific conditions are also met:

- The transaction documented in the past documentation is the same type as the transaction in the current year;
- The transactions documented in the past documentation are undertaken with the same related parties;
- The past documentation was prepared in accordance with the requirements under the rules, properly dated and prepared in English; and

- The information contained in the past documentation on the following matters remains relevant in the current year:
    - The commercial or financial relations between the taxpayer and its related parties;
    - The conditions made or imposed between the taxpayer and its related parties;
    - The transfer pricing method used for the transaction; and
    - The arm's length conditions within the meaning of Section 34D, including comparability with the conditions/circumstances observed between independent parties.

To adopt past documentation as qualifying documentation for Years 2 and 3 (subsequent to the preparation of contemporaneous documentation in Year 1), taxpayers are required to prepare a "simplified documentation" comprising:

- A declaration confirming that the conditions/circumstances (in Years 2 and 3) met the conditions stated above; and
- The past documentation as an attachment.

The simplified documentation must be prepared by the tax return filing due date, and would have to be submitted upon request.

A taxpayer that qualifies for simplified documentation nonetheless has the option to prepare new documentation.

TP adjustments and surcharge

The existing Section 34D of the SITA empowers the IRAS to make a tax adjustment if the taxpayer's taxable profit is understated due to non-arm's-length related-party transactions.

Section 34D has been significantly expanded to clarify that the determination of the arm's length principle would also consider arm's length "circumstances," that is, whether third parties would reasonably enter or not enter into similar transactions/arrangements. The new legislation provides the IRAS with the power to disregard the form of actual commercial or financial relations between related parties when the substance of the transaction is inconsistent with the form of the transaction, and allows the IRAS to make necessary adjustments.

The new guidelines include a substantial new rewrite with explicit mention of transfer pricing adjustments in paragraphs 5.117 to 5.124.

The new Section 34E also introduces a new surcharge on any transfer pricing adjustments made by the IRAS.

When the IRAS has made a transfer pricing adjustment under Section 34D to increase the amount of income, reduce the amount of deduction/allowance, or reduce the amount of loss, a surcharge equal to 5 percent of the amount of increase in income or reduction in deduction, allowance, or losses will be imposed.

The surcharge applies whether or not any additional tax is payable arising from the adjustments (for example, when unabsorbed tax losses or a pioneer incentive exemption is available), and is payable within one month from the issuance of the notice of surcharge.

The surcharge will apply from YA 2019.

Observations

The new legislation and rules represent a significant move from the current, practice-based regime to a rule-based one.

Although the key requirements of preparing and updating transfer pricing documentation remain largely unchanged, the introduction of a specific transfer pricing penalty and surcharge raises the cost of noncompliance with the arm's length principle and documentation requirements considerably.

The introduction of the additional exemption threshold based on annual gross revenue would relieve smaller companies from the transfer pricing documentation requirements; however, its application is somewhat complex, particularly in the years subsequent to YA 2019.

More importantly, the onus is on the taxpayer to demonstrate the applicability of the exemption to its circumstances, taking into careful consideration that a wrong determination could now give rise to a penalty under the new Section 34F(8).

Similarly, in relying on past documentation as qualifying documentation, the onus is also on the taxpayer to show that the relevant conditions have been met, bearing in mind that if the past documentation is inappropriately relied on as current documentation, the penalty/fine could rise.

The guidelines therefore suggest that notwithstanding the above, "to better manage their transfer pricing risk, IRAS encourages taxpayers to prepare TP documentation following the TP Documentation Rules and the guidance provided in this section."

With respect to TPD for YA 2018, many taxpayers have prepared new documentation, or have undertaken a major update of their documentation for YA 2015, following the release of mandatory documentation requirements in the TP guidelines in 2015. Those taxpayers are required to conduct a major update of the documentation in YA 2018. In this regard, the new guidelines (at paragraph 6.36) specifically cater for such "seamless" transition between the old regime and the new, by accepting that past documentation prepared before the enactment of Section 34F may still be considered as qualifying documentation for future years. Therefore, those taxpayers should prepare new documentation (or conduct a major update of the documentation prepared in YA 2015) for YA 2018, thus ensuring that they are in compliance with the current requirements for YA 2018, and being assured that the YA 2018 documentation can be used as qualifying documentation (provided conditions are met) in subsequent years.

The newly introduced surcharge applies to all transfer pricing adjustments, irrespective of whether there is tax payable. For companies that do not pay tax (for example, because of tax losses or tax incentives), it would be necessary to evaluate the sufficiency of existing documentation to ensure that these are appropriately prepared or updated to meet the new requirements and to minimize the incidence of a surcharge.

With the new mandatory documentation requirements and the introduction of significant penalties, as well as a substantial rewrite of the guidelines with explicit mention of transfer pricing adjustments, the IRAS is sending a clear signal that it is moving from a practice-based approach to a formal transfer pricing regime whereby it will seek to enforce compliance, including the imposition of penalties.

Therefore, taxpayers should ensure that they have proper and contemporaneous documentation. More importantly, with the stakes for noncompliance raised considerably under these changes, companies should also ensure that they devote appropriate attention and processes to address related-party transactions and compliance with the new requirements.

— See Jee Chang (Singapore)
Partner
Deloitte Singapore
jcsee@deloitte.com

Lee Siew Ying (Singapore)
Senior Manager
Deloitte Singapore
sylee@deloitte.com

IRS issues national security modification to country-by-country reporting rules

The Internal Revenue Service on 30 March issued Notice 2018-31, which states that the IRS and Treasury intend to amend Treas. Reg. §1.6038-4 to incorporate guidance to US multinational enterprise (MNE) groups that are specified national security contractors, so that those contractors may file their country-by-country (CbC) reports in the modified manner described in the guidance.

The term "specified national security contractor" is defined as a US MNE group 50 percent of whose annual revenue, as determined in accordance with US generally accepted accounting principles, in the preceding reporting period is attributable to contracts with the Department of Defense or other US government intelligence or security agencies.

Based on consultations with the Department of Defense subsequent to the promulgation of the final CbC regulations, the Treasury Department and the IRS have determined that CbC reports do require modifications for information related to national security.

To ensure that originally filed CbC reports are not automatically exchanged, specified national security contractors that are filing an amended Form 8975 and Schedules A (Form 8975) to supersede an already filed Form 8975 and Schedules A (Form 8975) should do so by April 20, 2018, if filing an amended federal income tax return on paper, or by May 25, 2018, if filing electronically.

The notice will apply to CbC reports and amended CbC reports filed after March 30, 2018.
URL: https://www.irs.gov/pub/irs-drop/n-18-31.pdf

— Joseph Tobin (Washington, DC)
Principal
Deloitte Tax LLP
jtobin@deloitte.com

Dave Varley (Washington, DC)
Principal
Deloitte Tax LLP
dvarley@deloitte.com

James Hawes (Washington, DC)
Senior Manager
Deloitte Tax LLP
jhawes@deloitte.com

2017 US APA Report shows continued strong interest in APAs

The Internal Revenue Service on March 30 released Announcement 2018-08, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2017. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a summary of recent APA developments in the APMA Program and a statistical snapshot of the program's APA activities during 2017.

Transfer pricing enforcement is expected to increase throughout the world as countries adopt the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) final recommendations, including the enactment of country-by-country (CbC) reporting requirements. In addition, many US and foreign multinational groups have begun reviewing their existing structures and transfer pricing policies in light of the passage of the Tax Cuts and Jobs Act of 2017 (TCJA), which may result in operational restructurings and transfer pricing policy changes. The TCJA includes several new international tax provisions that have created complex transfer pricing and international tax issues for both US and foreign multinational groups. Consequently, the certainty provided by APAs will play an increasingly important role in transfer pricing risk management.

Statistical highlights of the APA annual report include:

- **Incoming APA requests:** The IRS received 101 APA applications (14 unilateral, 86 bilateral, and 1 multilateral) in 2017, a similar number to the 98 APA applications received in 2016.
- **Large increase in completed APAs:** During the 2017 calendar year, APMA closed 116 APAs (30 unilateral, 85 bilateral, and 1 multilateral), compared to 86 APAs in 2016 and 110 APAs in 2015, while reporting a decrease in staffing levels in the APMA Program at the end of 2017 compared to the end of 2016. APA renewals accounted for 70 of the 116 APAs executed (or just over 60 percent), with 22 unilateral and 48 bilateral renewals. Twenty-two percent of all APAs included rollbacks. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.
- **Treaty partners involved in bilateral APAs:** In 2017 Japan accounted for 38 percent of bilateral APA requests filed, the largest share of any country. India accounted for 21 percent, showing the continued popularity of US-India bilateral APA requests since the IRS began accepting applications for bilateral APAs with

India in February 2016. Other countries accounting for meaningful percentages of filed, pending, or completed APAs with the United States are Canada, China, Germany, Korea, Mexico, Switzerland, and the United Kingdom.

Nearly three-quarters of the total number of bilateral APAs executed in 2017 involved bilateral APAs with either Japan or Canada. Based on the filed APA requests during 2017 and the IRS's pending inventory of APAs, the percentage of completed APAs with Japan and Canada is expected to decrease as a percentage of the total as other countries become more active in the APA process.

- **Months to complete APAs:** In 2017, the median time to complete a unilateral APA and a bilateral APA was 31.0 months and 35.9 months, respectively. In 2016, the median time to complete a unilateral APA and a bilateral APA was 15.4 months and 35.6 months, respectively. Overall, the median time required to complete the 116 APAs executed in 2017 was 33.8 months, one month slower than in 2016.

  Processing time for unilateral APAs increased significantly from the prior year. Unlike bilateral APAs, which involve treaty partners, unilateral APAs and their processing time are more controlled by APMA. Due to significantly smaller volumes of unilateral APAs compared to bilateral APAs, the median processing time for unilateral APAs tends to exhibit higher levels of variability than for bilateral APAs. Processing time for bilateral APAs increased slightly from the prior year. For each of the last five years, the median processing time for bilateral APAs has ranged from approximately 35 months to 38 months.

  Taxpayers renewing APAs benefitted from faster processing times for their APA requests. For renewal unilateral and bilateral APAs, the median processing time was 30.5 months, compared to the median processing time for new unilateral and bilateral APAs of 43.0 months. The median processing time required to complete new APAs decreased slightly from 46.7 months in 2016 to 43.0 months in 2017.
- **APA inventory:** The APMA Program had 386 cases in active inventory at the end of 2017: 57 unilateral APAs, 321 bilateral APAs, and 8 multilateral APAs. The number of pending APAs has continued to decline since 2015.
- **Term length of APAs (including rollback years):** Of the APAs executed in 2017, 38 cases had a five-year term including rollback years, while 68 cases had terms of six years or longer. The average term length in 2017 was seven years, compared to six years in the previous year. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA request took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.
- **Staffing:** As of December 30, 2017, the APMA Program was comprised of 55 team leaders, 17 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to 2016, this represents a decrease of seven team leaders and three economists. The team leader groups are organized by country, with each group having responsibility for multiple countries. Because of the large volume of cases with certain treaty partners, some countries are the responsibility of more than one group.
- **Cancellations, revocations, and withdrawals:** No APAs were cancelled or revoked during 2017. Eight APA requests (one unilateral, six bilateral, and one multilateral) were withdrawn in 2017, which is significantly lower than the 24 applications withdrawn in 2016, and more consistent with the 10 applications withdrawn in 2015.
- **APAs executed by industry:** In 2017, manufacturing and wholesale/retail trade accounted for 41 percent and 37 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (77 percent of such cases).
- **Covered transactions and transfer pricing methods:** Forty-four percent of the transactions covered in APAs executed in 2017 involved the sale of tangible goods, 35 percent involved the provision of services, and 21 percent involved the use of intangible property, which is consistent with the covered transactions in 2016. For potential cost sharing APAs, taxpayers should also consider that the preamble to the final cost sharing regulations under Treas. Reg. §1.482-7 provides that the IRS has the authority to negotiate an APA covering a platform contribution transaction and include a commensurate with income waiver.

  The comparable profits method (CPM) was used to evaluate 87 percent of the transactions involving the transfer of tangible and intangible property in 2017. Of those transactions, 85 percent used the operating margin as the profit level indicator (PLI) and 15 percent used other PLIs, such as the Berry ratio and return on assets or capital employed.

For services transactions, the most frequently applied method was also the CPM (86 percent of cases). Of those services transactions applying the CPM, 62 percent used the operating margin as the PLI. In 2017, the majority of APAs that covered services transactions also included tangible or intangible transactions, which were not tested under a separate PLI.

- **Adjustment mechanisms:** The majority of the transactions covered in APAs executed in 2017 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party's results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2017 executed APAs include an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.
- **APA boilerplate and APMA Program contact information:** The annual report also includes the latest version of the APMA Program's model APA agreement and a link to the list of primary APMA Program contacts. The model APA agreement has been unchanged since 2009; however, APMA solicited comments on a proposed major revision in September 2017, which has yet to be finalized.

The APMA Program also recently announced a significant increase in user fees to request an APA, for user fees paid after June 30, 2018, and December 31, 2018. Taxpayers that are planning to request an APA in the next 12 to 18 months should consider expediting the payment of the APA user fee prior to those dates, through what is known as a "dollar file" APA request, to take advantage of the existing lower user fees. For prior coverage, see Global Transfer Pricing Alert 18-004.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-18-004-8-february-2018.pdf

In light of the BEPS final reports and the adoption of CbC reporting requirements by many jurisdictions and corresponding increased audit activity, the demand for APAs will undoubtedly continue to be strong.

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

Dave Varley (Washington, DC)
Principal
Deloitte Tax LLP
dvarley@deloitte.com

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

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

Jamie Hawes (Washington, DC)
Senior Manager
Deloitte Tax LLP
jhawes@deloitte.com

Ukraine clarifies recent amendments to transfer pricing rules for PEs

The Ukrainian Tax Authority has issued a letter to clarify issues related to the recent amendments to the Ukrainian transfer pricing rules.

According to Letter No. 6185/7/99-99-15-02-01-17, 1 March 2018, transactions between a nonresident company and its permanent establishment (PE) in Ukraine will be recognized as controlled for transfer pricing purposes if the volume of the transactions with each counterparty during the reporting period exceeds UAH 10 million. This treatment follows a literal reading of the Ukrainian transfer pricing rules. However, considering that the nonresident entity and its permanent establishment may be treated as a single legal entity, there might be questions as to how transactions within a legal entity may be deemed to be controlled.
URL: http://sfs.gov.ua/zakonodavstvo/podatkove-zakonodavstvo/listi-dps/72854.html

The new letter also clarifies that business transactions between Ukrainian residents and the Ukrainian PE of a nonresident are not recognized as controlled for transfer pricing purposes, even though the tax authorities had previously taken a contrary position in Letter №21974/6/99-99-19-02-02-15, dated 19 November 2015.
URL: http://sfs.gov.ua/baneryi/podatkovi-konsultatsii/konsultatsii-dlya-yuridichnih-osib/print-64585.html

In December 2017, Ukraine's Cabinet of Ministers updated the list of low-tax jurisdictions. Business transactions between Ukrainian taxpayers and nonresidents registered in those jurisdictions may be treated as controlled transactions for transfer pricing purposes (irrespective of whether the taxpayer and the person resident in the listed country are related parties). There was some uncertainty regarding the list's date of application, and the tax authorities have now confirmed that the updated list applies to transactions entered into on or after 1 January 2018.

To determine whether a taxpayer's business transactions are to be treated as controlled, the volume of the transactions must be calculated based on arm's length prices (rather than contractual prices, which previously were commonly used in practice).

Self-adjustments regarding controlled transactions performed in 2015 and 2016 must be made in accordance with the regulations in effect at the time of the adjustments. This allows the adjustment of 2015 and 2016 transactions according to the regulations now in force (to the maximum/minimum market range value, rather than the median value).

Documents and information required for transfer pricing control are to be kept by the taxpayer for a period of 2555 days.

— Alexander Cherinko (Kyiv)
Partner
Deloitte Ukraine
acherinko@deloitte.ua

Oleksandr Yampolskyi (Kyiv)
Manager
Deloitte Ukraine
oyampolskyi@deloitte.ua

Draft of new measures on the implementation of domestic transfer pricing provisions issued in Italy for public consultation

Italy's Ministry of Economy and Finance on February 23 launched a public consultation on several transfer pricing issues. Specifically, the ministry requested comments and suggestions from all potentially interested parties on the following documents:

1. A draft decree providing the relevant guidelines to address arm's length issues in compliance with the OECD transfer pricing guidelines;
2. A draft of the regulations implementing the newly introduced unilateral corresponding adjustment procedure (new Art. 31 quarter of Decree 600/1973); and
3. An Italian courtesy translation of the OECD transfer pricing guidelines.

The above documents have been released for public consultations to be concluded by March 21. The results of the consultation will be made available to the public.

Draft decree addressing the implementation of the arm's length principle

The draft decree contains measures aimed at implementing the OECD transfer pricing guidelines within the Italian tax system. Preliminarily, the decree addresses the following issues:

- A definition of "associated enterprises," both related to legal and de facto control;
- An illustration of the concept of comparability under the five comparability factors in compliance with Chapter III of the OECD transfer pricing guidelines;
- A description of the relevant transfer pricing methods and the criteria for selecting the most appropriate one, according to the OECD transfer pricing guidelines.

Furthermore, a precise definition of the concept of "arm's length range," which has been missing from Italian regulations, has been provided, as the "range of values resulting from the indicator financial resources selected in accordance with the most appropriate method rule, where they refer to a number of uncontrolled transactions that are equally comparable to the transaction under analysis."

The draft clarifies that if the value of the tested transaction (or the margin of the tested party) falls outside the arm's length range, the tax authorities will make an adjustment to bring that value within the range. The new provision represents a step forward in providing taxpayers with more precise indications; however, it does not clarify to which point in the range (for example, first quartile, median…) the adjustment should bring the tested party's profitability to make it arm's length.

Finally, the decree contains a final clause that allows the Revenue Agency to issue further instructions/regulations, based on future amendments to the OECD transfer pricing guidelines.

Draft regulations on unilateral corresponding adjustments

The set of draft documents released for public consultation contains a draft regulation to implement the provisions of Article 31-quater of Decree 600/1973 (recently introduced by Law Decree 50/2017), which will provide Italian companies with a new tool to avoid double taxation in case of transfer pricing adjustments made by foreign tax authorities under the arms' length principle.

Under the draft regulations, if a decrease in the Italian taxable income was necessary to avoid double taxation deriving from a transfer pricing assessment, a downward adjustment would be possible in the future, not only by means of the mutual agreement procedure provided under the EU Arbitration Convention (Convention 90/436/EC of 23 July 1990), or the applicable income tax treaties, but also through a specific request for a "correlative adjustment" to be filed by the Italian taxpayer with the domestic competent authority.

Such a unilateral adjustment, which would allow the taxpayer to recover the excess taxes paid in Italy, could be claimed only in the case of transfer pricing adjustments that meet the following conditions:

- The primary adjustment must comply with the arm's length principle;
- The state that made the primary adjustment must have entered into an income tax treaty with Italy that includes an effective exchange of information provision; and
- The primary adjustment must be final in the other country.

To demonstrate that the primary adjustment is final, the taxpayer must provide the Revenue Agency with a certificate issued by the foreign state confirming that that is the case.

The draft regulations indicate how to file the application, and the Revenue Agency has 180 days to respond. However, should the Revenue Agency decide to request information from the other jurisdiction under a legitimate exchange of information procedure, that term will be suspended.

The Revenue Agency must issue a decision accepting or rejecting the claim within the 180-day period. If the request is accepted, the Revenue Agency will determine the taxpayer's right to receive a refund (currently, the possibility of allowing the use of the relevant tax credit to offset an equivalent amount of taxes due in the corporate income tax return is not contemplated) based on the amount of the corresponding adjustment.

If the relevant conditions are met, the taxpayer would retain the right to request the activation of a MAP, either under the relevant tax treaty or the Arbitration Convention.

Draft translation of OECD transfer pricing guidelines

As mentioned above, the Ministry of Finance has published a draft translation of the most significant sections of 2017 OECD transfer pricing guidelines, Chapter IV and Chapter V in their entirety.

The ministry describes the translation as a "courtesy translation," and it has been issued with the goal of simplifying implementation of the OECD transfer pricing guidelines. In cases of discrepancies between the translation and the original, it is reasonable to assume that the OECD guidelines' original language will prevail.

— Aldo Castoldi (Milan)
Partner
Deloitte Italy
acastoldi@sts.deloitte.it

Stefano Lavore (Milan)
Manager
Deloitte Italy
slavore@sts.deloitte.it