Arm's Length Standard
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OECD releases discussion draft on transfer pricing of financial transactions

The Organisation for Economic Co-operation and Development (OECD) on 3 July 2018 released a non-consensus discussion draft on the transfer pricing aspects of financial transactions. This discussion draft is part of actions 8-10 of the base erosion and profit shifting (BEPS) project, which began in 2013.

The 2015 final report on BEPS actions 8-10 mandated follow-up work on this topic. Pursuant to that mandate, the discussion draft aims to clarify the application of the OECD transfer pricing guidelines (TPG) to financial transactions, in particular, the accurate delineation analysis under Chapter I.[1] The discussion draft addresses debt-versus-equity determinations as well as specific issues related to financial transactions such as rates of return, intragroup loans, cash pooling, hedging, guarantees, and captive insurance companies.

The OECD has invited interested parties to submit comments on the discussion draft by 7 September 2018.

Debt versus equity determinations

The discussion draft includes guidance that reflects an approach of accurate delineation of the actual transaction to determine the capital structure (the mix and types of debt and equity) used to fund an entity within a multinational enterprise (MNE) group. The draft guidance indicates that an approach of accurate delineation, which may include a multifactor analysis, is necessary before pricing a loan to determine whether the purported loan is regarded correctly, or should be recharacterized as equity for tax purposes.[2] Furthermore, the draft guidance suggests that the recharacterization as equity of a purported loan is not an all-or-nothing consideration; rather, the draft guidance appears to allow a bifurcation of a purported loan between debt and equity as part of the accurate delineation analysis.[3]

As stated in the discussion draft, accurate delineation of financial transactions should begin with the thorough identification of economically relevant characteristics of the transaction, consistent with the application to other transactions. These include:

- An examination of the contractual terms of the transaction;
- The functions performed, the assets used, and the risks assumed;
- The characteristics of the financial products or services;
- The economic circumstances of the parties and the market; and
- The business strategies pursued by the parties.

The discussion draft specifically mentions factors that may be useful indicators in accurately delineating a loan. While it clearly states that the draft guidance is not intended to prevent countries from implementing other approaches to address capital structure and interest deductibility, it lists a number of factors that can be used to distinguish intercompany debt from other forms of funding such as equity, including the following:

- The presence or absence of a fixed repayment date;
- The obligation to pay interest;
- The right to enforce payment of principal and interest;
- The status of the funder in comparison to regular corporate creditors;
- The existence of financial covenants and security;
- The source of interest payments;
- The ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- The extent to which the advance is used to acquire capital assets; and
- The purported debtor's failure to repay on the due date or to seek a postponement.

In applying the arm's length principle to a financial transaction, the guidance advocates for consideration of the conditions that independent parties would have agreed to in comparable circumstances. Further, it is necessary to consider the options realistically available to each of the parties to the transaction.[4]

Considering that many jurisdictions follow a fixed-ratio thin capitalization approach and others, including the United States, have issued specific regulations that govern the debt-equity characterization that may go beyond a transfer pricing analysis, a key issue going forward will be how individual countries adopt this portion of the OECD draft guidance.

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[1] All references to the OECD TPG are references to the 2017 version of the TPG.
[2] This approach of accurate delineation applies to certain financial transactions mentioned in the discussion draft including intragroup loans, cash pooling, hedging, guarantees, and captive insurance arrangements.
[3] The bifurcation approach is consistent with the draft Treas. Reg. §1.385, although the final regulations moved away from this methodology.
[4] For example, in the case of an entity that advances funds, other investment opportunities may be contemplated.

Risk-free and risk-adjusted rates of return

The discussion draft states that when the accurate delineation analysis shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain.[5]

The discussion draft discusses the approach to use the interest rate on certain government-issued securities as a reference rate for a risk-free return. The guidance also mentions that government-issued securities are not the only reference for estimating risk-free rates, and other alternatives may be considered based on the prevailing facts and circumstances of each case.

The draft guidance states that in a situation in which a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of or control over any other specific risk, it could generally expect only a risk-adjusted rate of return on its funding (that is, it would not be entitled to a return on its funding beyond fixed, risk-adjusted interest income). The discussion draft indicates that a risk-adjusted rate of return can be determined under different approaches, for example: comparable uncontrolled transactions, the addition of a risk premium to the risk-free return, or a cost of funds approach.

Treasury functions: Intragroup loans, cash pooling, and hedging

The discussion draft states that the organization of the treasury function will depend on the structure of the MNE group and the complexity of its operations. Differences in the treasury function may flow from variations in the function's degree of autonomy and the range of activities it performs. The draft guidance sets out transfer pricing considerations that arise from treasury activities such as intragroup loans, cash pooling, and hedging activities.

Intragroup loans

In determining the arm's length interest rate on intragroup loans, a number of factors should be considered, including:

- The lender's and borrower's perspectives;
- The borrower's credit rating;
- The effects of group membership (and associated implicit support);
- Incurrence and maintenance covenants;
- Guarantees; and
- Loan fees and charges associated with the transaction.

In considering the lender's perspective, the discussion draft suggests an evaluation of the lender's ability to bear the risks associated with the borrower's potential default on the loan. A similar concept is also seen in the section of the discussion draft on guarantees and the guarantor's ability to bear the financial risk associated with providing a contractual guarantee. Such an analysis is likely to be an important aspect of the accurate delineation of the transaction. However, the discussion draft does not offer any guidance or examples as to how the financial ability to bear the risk should be measured or evaluated.

Specific guidance is provided on considerations for conducting credit rating analyses and performing comparability adjustments to account for influences of controlled transactions and potential impact of passive association. The discussion draft acknowledges that credit ratings can serve as a useful measure of creditworthiness and to help identify potential comparables. Furthermore, the discussion draft highlights that in performing a credit rating analysis, it is important to note that the financial metrics of the borrower may be influenced by other controlled transactions. However, no guidance or examples are provided as to how these situations should be best addressed.

The discussion draft covers the issue of implicit support throughout, and the guidance on performing credit rating analyses is no exception. Rather than adopting a single top-down approach (starting with a parental credit rating and notching down) or bottom-up approach (starting with a stand-alone borrower credit rating and notching up) to implicit

[5] The funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in Chapter I of the TPG.

support consideration, the discussion draft suggests a facts-and circumstances-driven approach based on the entity's relative importance to the group. The discussion draft suggests that in cases in which the borrower would be more likely to receive support from other group members than a less integral member, the borrower's credit rating is likely to be more closely linked to the group rating. Conversely, when a borrower is determined to be less likely to receive group support in more limited circumstances, it may be appropriate to first consider a stand-alone credit rating of the entity and then modify the rating upward to account for implicit support.

The guidance emphasizes the importance of both quantitative and qualitative factors in determining arm's length pricing. Qualitative factors include both the effects of group membership, as discussed above, and also qualitative aspects of the borrower's business. While the draft guidance takes a separate entity approach to pricing, it looks beyond contractual terms to consider that the lender and borrower are related parties, that the funding is in fact intercompany and not third-party debt, and that the borrower is a member of a larger MNE. For example, consideration is given to the fact that intercompany loans are frequently subordinated to third-party loans in many jurisdictions. This suggests that there may be a need to perform a legal analysis with respect to bankruptcy laws and seniority. The guidance also highlights that covenants may be less important in a related-party context and that intragroup loans may effectively be secured lending even if no security is contractually given. Finally, consistent with paragraphs 1.164 through 1.167 of the TPG, the draft guidance considers the effects of group membership via implicit support, even in the absence of a contractual guarantee.

The discussion draft outlines the transfer pricing approaches to determine arm's length rates, including the comparable uncontrolled price (CUP) method, a cost of funds approach, and reliance on bank opinions. The guidelines indicate that the last item – reliance on bank opinions – generally would not be regarded as providing evidence of arm's length pricing.

Cash pooling

Cash pooling enables a group to benefit from more efficient cash management by (notionally or physically) bringing together the balances on separate bank accounts. The draft guidance indicates that accurate delineation of cash pooling arrangements would need to take into account the facts and circumstances of the balances transferred, but also the wider context of the conditions of the pooling arrangement as a whole.[6] The discussion draft mentions two broad pricing schemes for cash pooling transactions: rewarding the cash pool leader and rewarding the cash pool members. The appropriate basis on which to reward the cash pool leader depends on the specific facts and circumstances of the arrangement.[7]

The draft guidance discusses three approaches to allocating the benefits of cash pooling to the participating members (that are not necessarily mutually exclusive):

- Enhancing the interest rate for depositors and borrowers;
- Applying the same interest rates for depositors and borrowers;[8] and
- Allocating cash pooling benefits to depositors, and not borrowers, within the group (in situations in which there is genuine credit risk to the depositors).

The guidance mentions that cross-guarantees and set-off rights may be required between participants in the cash pool. The guidance also mentions that, in some circumstances, the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. In such cases, the discussion draft suggests, no guarantee fee would be due, and support in case of a default from another group member should be regarded as a capital contribution.

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[6] It is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (ii) how that benefit should be divided among members of the MNE group.
[7] An example is provided whereby the cash pool leader performs coordination services, but bears no credit risk and accordingly should earn rewards commensurate with a service provider. In a second example, the cash pool leader performs additional functions, controls and bears the financial risks contractually allocated to it, and has the financial capacity to bear those risks, and should be compensated commensurately.
[8] This applies in a situation in which all cash pool members have the same or similar credit profile.

When a centralized treasury function arranges a hedging contract that an operating company enters into, the draft guidance indicates that the centralized function can be seen as providing a service to the operating company and should be rewarded accordingly. When hedging positions are not matched within the same company, although the group position is protected, more difficult transfer pricing issues may arise.

Guarantees

The discussion draft provides guidance on how to accurately delineate and price financial guarantees.

As stated in the guidance, when the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, it is necessary to consider whether a portion (incremental borrowing capacity) of the loan from the lender should be more accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower),[9] and whether the guarantee fee paid with respect to the loan portion is arm's length.

The draft guidance discusses both explicit guarantees (legally binding contracts) and implicit guarantees (anything less than a legally binding commitment). In general, the benefit of any such implicit support would arise from passive association and not from the provision of a service for which a fee would be payable. In an explicit guarantee, a borrower generally would not be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return (that is, a cost of debt-funding lower than its non-guaranteed borrowing costs adjusted for implicit support and costs associated with the guarantee).
The draft guidance describes five pricing approaches for circumstances in which a guarantee fee is found to be appropriate:

- The CUP method (although finding sufficiently similar guarantees between unrelated parties may be unlikely);
- The yield (differential) approach;
- The cost approach;
- The valuation of expected loss approach; and
- The capital support method.

The yield approach prices the guarantee based on the benefit provided to the borrower (that is, from the borrower's perspective), whereas the cost, valuation of expected loss, and capital support methods price the guarantee based on the cost to the guarantor (that is, from the guarantor's perspective). It is worth noting that a capital support approach appears to presume that an improvement in the borrower's credit rating can be accomplished solely through a capital infusion, without regard to the myriad of other inputs typically considered in a credit rating analysis.

Captive insurance companies

Some MNE groups manage risks within the group through a captive insurance company, a group member that provides insurance-type services exclusively or primarily to members of the group. The discussion draft provides guidance on applying the arm's length principle to these transactions. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction is accurately delineated as such. The draft guidance provides indicators, all or substantially all of which would typically be expected in an independent insurer:

- Diversification and pooling of risk in the captive insurer;
- The group's economic capital position has improved as a result of diversification and there is therefore a real economic impact for the group as a whole (that is, the captive insurer either: (i) does not only insure group risks but diversifies those group risks by inclusion within its portfolio of a significant proportion of non-group risks, or (ii) it reinsures a significant portion of the risks it insures outside of the MNE group);
- Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels;
- The insured risk would otherwise be insurable outside the group;
- The captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise; and
- The captive has a real possibility of suffering losses.

[9] A similar question was not posed with regards to implicit support.

Two methods are discussed that may be appropriate for the pricing of premiums: CUPs from available comparable arrangements between unrelated parties (or internal comparables) and actuarial analysis. The draft guidance also provides for a method that builds to an arm's length level of profitability as the sum of underwriting profit plus investment income. Further, the draft discussion provides guidance on the pricing of agency sales and arrangements whereby a captive is used to achieve synergies for the MNE group.

Conclusion and key takeaways

The discussion draft provides guidance on the transfer pricing aspects of financial transactions including treasury functions, intragroup loans, hedging, cash pooling, financial guarantees, and captive insurance.

Not only does the guidance provide methods for determining the arm's length compensation for financial transactions, it also indicates that an accurate delineation is necessary before pricing a financial transaction to determine whether the transaction is characterized correctly, or should be recharacterized for tax purposes. To accurately delineate financial transactions, the discussion draft indicates it is necessary to perform an examination of the contractual terms of the transaction; the functions performed, the assets used, and the risks assumed, the characteristics of the financial products or services; the economic circumstances of the parties and the market; and the business strategies pursued by the parties.

Overall, the guidance provided in the discussion draft highlights a potential need for MNEs to revisit and develop intragroup policies (and revisit associated funding agreements) to address any ambiguity regarding how tax authorities might interpret their intragroup financing transactions.

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India's CBDT releases guidance on appropriate use of country-by-country reports

India's Central Board of Direct Taxes on 27 June 2018 released an internal instruction providing guidance on appropriate use of country-by-country reports (CbCRs) in India. The instruction provides clarity on certain fundamental aspects regarding the use of CbCR information by the Indian tax authorities. The instruction also discusses the processes proposed to monitor, review, and control the use of CbCR information by transfer pricing officers (TPOs).

Background

To address issues regarding profit shifting by multinational enterprise (MNE) groups, and to enhance the coherence of international tax rules, the OECD and the G20 countries in 2013 devised a 15-point action plan under the base erosion & profit shifting (BEPS) project. Action 13 included revised standards for transfer pricing documentation and recommended a three-tier standardized approach.

In keeping with India's commitment to implementing the recommendations of the BEPS action 13 final report, India introduced the CbCR and master file regime in the Indian Income Tax Act, 1961 through the Finance Act 2016 (by inserting new section 286 and introducing relevant provisions under section 92D), effective 1 April 2016.

As per Action 13 guidance, the CbCR is to be filed in the jurisdiction of tax residence of the ultimate parent entity of the MNE group, and the parent jurisdiction will share the report with other jurisdictions where the group operates, through an automatic exchange mechanism. India has adopted an approach in line with the Action 13 guidance.

To facilitate the automatic exchange of CbCRs, India has become a signatory to the multilateral competent authority agreement for automatic exchange of country-by-country reports (MCAA), through which India will exchange and receive CbCRs for FY 2016-17 (the first year the CbCR requirement applies in India) and years going forward.

The CBDT acknowledges that some countries have not signed and/or ratified the MCAA yet. In those cases, the instruction clarifies that India will attempt to enter into bilateral competent authority agreements (BCAAs) for the automatic exchange of CbCR with those countries on the basis of its tax treaties or its tax information exchange agreements. This would be critical for international groups (IGs) headquartered in countries such as China and the United States.

Now that the first year of Action 13 implementation in India is over, taxpayers have raised concerns regarding how the CbCR information would be used by the tax authorities in India. The CBDT's recent issuance of Instruction No. 02/2018, dated 27 June 2018, on the appropriate use of CbCR information in India is a positive step towards addressing some taxpayer concerns, as this instruction provides clarity on certain fundamental aspects of use of such information by the Indian tax authorities.

The salient features of the instruction are discussed below.

Access to CbCR

Access to CbCRs filed in India, as well as CbCRs exchanged by other jurisdictions with India, will be restricted to specified senior authorities. These reports will be accessed primarily by the Competent Authority of India [Joint Secretary, FT & TR-1 and Joint Secretary, FT & TR-II in CBDT] and Director General of Income-tax [Risk Assessment] (DGRA), in accordance with the provisions of the tax treaties and the Income Tax Act, respectively.

If a constituent entity is selected for scrutiny, based on a risk assessment by the Centralised Risk Assessment Unit (CRAU) of DGRA, the jurisdictional TPO will have access to the information regarding that constituent entity.

The CRAU of DGRA will formulate the standard operating procedures for TPOs.

Appropriate use of CbCRs

The instruction provides a framework for the appropriate use of CbCR information by TPOs during a transfer pricing audit, which is aligned to a large extent with BEPS action 13 guidance. Under the guidance, TPOs may use CBCR information for three principal purposes.

High-level transfer pricing risk assessment: The CRAU's risk-based assessment could provide insights on potential risk on a taxpayer's transfer pricing arrangements, which may necessitate further examination by the TPO. For this purpose, a tax audit could be planned by selecting the case for scrutiny. Using the CbCR information as a basis, during the course of the transfer pricing audit, the TPO is empowered to:

- Make further inquiries on the taxpayer's transfer pricing arrangements; and
- Make inquiries into tax matters identified using other data sources or arising during the course of a tax audit.

The instruction clarifies that the queries raised by the TPO need not be restricted to the potential risks identified earlier by the CRAU (thus providing the TPOs with a broader purview for audit).

Further, the instruction confirms that the CbCR information would not be used as the only source considered to propose a transfer pricing adjustment. Rather, adjustments must be made in accordance with the Indian transfer pricing regulations.

Assessment of other BEPS-related risks: CbCR information could be used to identify indicators of possible tax risks unrelated to transfer pricing (such as hybrid entities, hybrid financial instruments, conduit companies, resorting to profit shifting using the contractual allocation of risk, pricing of intangibles, etc.). Further inquiries could be made to examine and analyze such risk for the purpose of concluding on potential tax risk of base erosion or profit shifting. However, the instruction clarifies that CbCR information cannot constitute conclusive evidence that an international group (IG) is engaged in other forms of BEPS activities.

Economical and statistical analysis: To understand the benefits, use, and risk of CbC reporting and the tax system, the instruction states that the information obtained through the CbCR may be used for economic and statistical analysis, which is consistent with the provisions of tax treaties.

Inappropriate use of CbCR information

Use of CbCR information would be considered "inappropriate use" in the following circumstances:

- If the information is used as a substitute for a detailed transfer pricing analysis of international transactions and the determination of an arm's length price; and
- If the information is used as the only evidence to propose a transfer pricing adjustment.

Safeguarding confidentiality of CbCRs

The CBDT acknowledges the relevance of safeguarding the confidentiality of information submitted in CbCRs as not only a legal requirement under the provisions of tax treaties, but also an international obligation. Any breach of information may have serious implications for India's ability to receive information from other jurisdictions in the future.

Thus, the instruction ensures that CbCRs received from other jurisdictions will conform to the requirements of confidentiality under tax treaties. Similarly, CbCRs filed in India will abide by the confidentiality provisions of the Income Tax Act.

Additionally, the CBDT instructs the specified senior tax authorities to ensure that field tax officers handling CbCRs (exchanged under the tax treaties) should maintain the strict confidentiality of the CbCRs as per the detailed guidelines provided in Chapter VII of the Manual on Exchange of Information.

Monitoring, control, and review of use of information

The use of information by TPOs in tax audits will be monitored by jurisdictional CIT (Transfer Pricing). Any breach of appropriate use of CbCR information would be brought to the notice of the Competent Authority of India, who is committed to disclose such breaches to the OECD's Coordinating Body Secretariat.

To review the appropriate use conditions on a regular basis, the Competent Authority of India requires quarterly filing of a consolidated report by the Principal CIT (International Taxation & Transfer Pricing) in the format specified, commencing from 1 January 2019.

The instruction also empowers taxpayers to raise concerns over breaches of appropriate use conditions to the jurisdictional CIT (Transfer Pricing). If those concerns are not resolved by the CIT, the issue may be escalated to the Competent Authority of India.

Any adjustments made to a taxpayer's income based on inappropriate use of the information in a CbCR will be promptly conceded by the Competent Authority of India in mutual agreement procedure (MAP) proceedings.

Key open issues

The instruction broadly addresses many taxpayer concerns. However, more information/clarification on some of the below points would be welcome:

- Parameters for the risk-based assessment, subsequent to which the CbCR information would be shared with the TPO, to educate taxpayers of the reasons for selection.
- Details on the time and manner for resolving taxpayers' concerns regarding a breach of appropriate use conditions could provide some comfort to taxpayers.

- The procedure (including timelines) to be followed by the Competent Authority in MAP proceedings in relation to adjustment made based on the inappropriate use of CbCR information would be useful to know.
- Details regarding who would be conducting the assessment of other BEPS-related risks of the CbCR information, and who would have the authority to undertake economic and statistical analysis of the CbCR information. It would also be helpful to know the mechanism that will be adopted to undertake the above assessment/analysis. Further, information on who would conduct tax audits and make further inquiries into identified potential tax risk (unrelated to transfer pricing) and how the CbCR information would be shared with the relevant tax officer.
- Whether TPOs will have access to CbCR information in relation to cases that have been selected for transfer pricing audit under the regular risk-based assessment.

Key takeaways

The CBDT's internal instruction is a positive step towards addressing taxpayers' concerns regarding the information submitted in the CbCR. However, more information on or clarification of some of the above highlighted aspects would be appreciated. It will be interesting to see how these instructions are implemented and enforced by the Indian tax authorities. Given the wide-ranging use of CbCR information, from a readiness perspective, taxpayers could endeavor to undertake a proactive risk assessment for queries likely to be raised by the Indian tax authorities.

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Ninth Circuit Court of Appeals reverses Tax Court in *Altera*, then withdraws opinion

The US Ninth Circuit Federal Court of Appeals on July 24, 2018, reversed the Tax Court decision in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015). At issue was the validity of 26 C.F.R. §1.482-7A(d)(2), which mandates that stock-based compensation (SBC) costs related to the intangible development activity of a qualified cost sharing arrangement (QCSA) must be included in the joint cost pool of the QCSA (the "all costs rule"). A three-judge panel held that the all costs rule is consistent with the arm's length standard as enunciated under section 482 and therefore that such costs must be included in the cost pool. However, on August 7, the court withdrew the opinion in the case, "to allow time for the reconstituted panel to confer on this appeal."

For further coverage of this development, please see the next issue of *Arm's Length Standard*.
URL: https://www2.deloitte.com/global/en/pages/tax/articles/arms-length-standard.html?id=us:2em:3na:als:awa:tax:081318&sfid=7011O000002Dmzc

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OECD releases new guidance on transactional profit split method and hard-to-value intangibles

The Organisation for Economic Co-operation and Development on June 21, 2018, released two consensus reports concerning the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG).[10] These reports are part of the base erosion and profit shifting project, which began in 2013.

The first report contains revised guidance on the transactional profit split method of Chapter II of the 2017 OECD TPG. The second report deals with the implementation of the OECD's approach to hard-to-value intangibles (HTVI) in Chapter VI of the 2017 OECD TPG. The guidance on the HTVI approach in Chapter VI was adopted in the final BEPS deliverable of October 5, 2015. Both of the 2018 reports are discussed below.

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[10] All references herein to the OECD TPG are references to the 2017 version of the TPG.

2018 profit split report

The June 21 profit split report is the fourth and final round of proposed guidance relating to the transactional profit split method. It contains new provisions and examples that replace the current versions of Section C of Part III, Chapter II of the 2017 OECD TPG and Annex II to Chapter II of the 2017 OECD TPG, respectively.

The immediately preceding round of guidance was a non-consensus discussion draft released on June 22, 2017. The 2018 profit split report retains the same basic approach of the 2017 discussion draft, but expands upon that draft, especially in the examples.

Overall, the 2018 profit split report continues to focus squarely on the question of how the "risk control" framework of the revised Chapter I of the TPG might apply in the context of:

1. The selection of the transactional profit split as the most appropriate transfer pricing method, and
2. The application of a split factor that may reasonably result in an arm's length outcome.

The three profit split indicators: The 2018 final report sets forth three factors the presence of which indicate that the transactional profit split method may be the most appropriate method. Those three factors are:

- Whether each party is making unique and valuable contributions;
- Whether the business operations of the parties are so highly integrated that the parties' contributions cannot be reliably evaluated in isolation from each other; and
- Whether the parties share the assumption of economically significant risks or separately assume closely related risks.

The 2018 final report also includes a definition of the term "unique and valuable contributions," which covers not just assets used (such as intangibles) but also "functions performed." Furthermore, the 2018 final report states that the existence of unique and valuable contributions is "perhaps the clearest indicator" that a transactional profit split may be appropriate.[11]

Several examples, which will be contained in Annex II to Chapter II of the OECD TPG, illustrate how these factors should be applied, both separately and in a single case:

- Unique and valuable contributions: Examples, 1, 2, 3, 4, and 5 (transfer of intangibles);
- Highly integrated business: Examples 6, 7, 8, and 9 (integration results in unique and valuable contributions);
- Shared assumption of economically significant risks or closely related risk: Example 10; and
- Combination of factors: Example 12.

Methods and factors to split profits: The 2018 final report contains the same two profit split methods as the 2017 discussion draft: the contribution analysis and the residual analysis. The contribution analysis divides profits on the basis of the relative contribution of the enterprises. The residual analysis is a two-step process: in the first step the returns that can be reliably benchmarked are determined, and in the second step the remaining profits are split using a contribution analysis. Example 11 illustrates a residual analysis.

Like the 2017 discussion draft, the 2018 final report eschews adopting a prescriptive list of profit splitting factors.[12] Profit split factors should be verifiable and based on internal accounting data or on measurable market data, if available.[13] Internal data such as assets, costs, and headcount may be used.[14] For self-developed assets, which may not be on the balance sheet, valuation techniques such as discounted cash flow may be used. Example 15 illustrates an asset-based allocation and Example 16 illustrates a cost-based allocation.

Profits to be split: The 2018 final report recognizes that it may be necessary to segment results of the enterprises to reflect the accurate delineation of the transactions that are subject of the profit split.

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[11] *See* 2018 Profit Split Report at ¶ 2.126.
[12] *Id*. at ¶ 2.166.
[13] *Id*.
[14] *Id*. at ¶¶ 2.169 to 2.173.

The measure of profits to be split will depend on the risks the enterprises share.[15] In many cases, operating profit may be the most appropriate measure of profits to split because the enterprises share in the risks of the entire business. However, if the enterprises share only the risks associated with the volume of sales and production of the products, and they do not share the risks associated with selling the products in the marketplace, then a split of gross profit may be appropriate. Examples 10, 14, and 16 and Par. 2.164 illustrate when it may be appropriate to split operating profit in comparison to other measures of profit such as gross profit.

The 2018 final report provides guidance on when it is appropriate to split actual or anticipated profits:

- The splitting of *actual* profits is appropriate when all the relevant parties share the assumption of the same economically significant risks or separately assume closely related, economically significant risks.
- A split of *anticipated* profits, in contrast, would be more appropriate if one of the parties does not share in the assumption of all of the economically significant risks.

These concepts are illustrated in Example 13 of the 2018 profit split report.

Whether actual or anticipated profits are split, the basis for splitting profits must be determined on the basis of the information known or reasonably foreseeable at the time the parties entered into the transaction.[16]

Observations on 2018 profit split report

In public consultations over previous non-consensus versions of the 2018 profit split report, there was significant discussion on how the risk control framework in Chapter I of the OECD TPG applied to transactional profit splits. The risk control framework includes guidance in the following paragraphs:

- Paragraph 1.94 states that if a party does and has the capability to financially assume a risk and it has the capability and performs the decision-making function with respect to the risk, the fact that other parties also exercise decision-making functions need not be considered in the allocation of risk;
- Paragraph 1.95 states that if two or more parties have the capability to assume a risk financially and have the capability and perform the decision-making function with respect to the risk, then the assumption of risk should be respected; and
- Paragraph 1.105 states, in part, that in circumstances when a party contributes to the control of risk, but does not assume the risk, compensation that takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate.

The final guidance cites paragraphs 1.95 and 1.105 but omits 1.94. If a tax administration interprets the failure of the OECD to cite paragraph 1.94 as indicative that only paragraphs 1.95 and 1.105 need be considered in the evaluation of the transactional profit split method, then some structures in which one party only contributes to control over economically significant risks, but does not assume them within the meaning of paragraph 1.94 in the accurately delineated transaction, might be inappropriately analyzed using a profit split rather than an alternative method that is consistent with the accurately delineated transaction.

Application of the profit split method can pose significant challenges. The examples in the 2018 final report, although helpful at a basic level, do not address some of the more challenging issues, and often assume away the situations that may be seen most often in practice, such as the presence of HTVI, what might constitute a "unique and valuable function," the determination of profits to be split, and profit splitting factors. As a result, careful planning and detailed documentation will be important, whether one wants to apply the profit split method or not. The additional uncertainty may lead to a renewed focus on the benefits of advance pricing agreements (APAs) and the mutual agreement procedure (MAP) process.

2018 HTVI report

The 2018 HTVI report has been incorporated as an annex to Chapter VI of the TPG. The 2018 HTVI report:

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[15] *Id*. at ¶ 2.162.
[16] *See* 2018 Profit Split Report at ¶ 2.161.

1. Presents the principles that should underlie the application of the HTVI approach by tax administrations;
2. Provides examples intended to clarify the application of the HTVI approach in different scenarios; and
3. Addresses the interaction between the HTVI approach and access to the MAP process under an applicable tax treaty.

The 2018 HTVI report focuses on information asymmetry between taxpayers and tax administrations, and states that the application of the HTVI approach should be underpinned by the following four principles:

- Tax administrations may consider *ex post* outcomes as presumptive evidence about the reasonableness of the assumptions of the *ex ante* pricing arrangements.
- In performing valuations, tax administrations should consider whether the associated enterprises could or should reasonably have known and considered *ex ante* the information related to the probability of achieving the actual income or cash flows, and whether it has considered such information. Thus, taxpayers have the possibility to rebut the presumptive evidence of *ex ante* pricing allegedly provided by the *ex post* outcome by demonstrating the reliability of the information supporting the pricing methodology adopted at the time of the transfer. The final guidance makes clear that tax authorities should not confuse the actual returns with the appropriate *ex ante* average of all possible returns appropriately probability weighted to value the *ex ante* average arm's length price at the time the transaction is entered into. This point was not included in the previous discussion draft, although it was extensively discussed in comments prepared by Deloitte Tax LLP and submitted to the OECD.
- When a revised valuation shows that the intangible was transferred at an undervalue or overvalue, the revised price may be assessed taking into account price adjustment clauses and/or contingent payments without regard to whether the original transaction contained such clauses.
- Tax administrations should apply audit practices to ensure that presumptive evidence based on *ex post* outcomes is identified and acted upon as early as possible.[17]

Significantly, the 2018 HTVI report includes language discussing the type of information that may be taken into account, saying that tax administrations may consider not only *ex post* outcomes but also any other relevant information related to the HTVI transaction that becomes available and that could or should reasonably have been known and considered by the taxpayer at the time of the transaction.[18] The 2018 HTVI report also makes clear that, even if the HTVI approach is not applicable to a particular transaction, an adjustment may still be appropriate under other parts of the OECD TPG (including other sections of Chapter VI) because, for example, the original valuation did not correctly value the potential value of the transferred intangible.[19]

Finally, the 2018 HTVI report states that tax administrations may make adjustments that reflect an alternative pricing structure that differs from the structure adopted by the taxpayer.[20] The guidance provides that such structure must be of a type that would have been made by independent enterprises in comparable circumstances, such as milestone payments, royalties with or without adjustable elements, or price adjustment clauses.[21] However, the guidance does not require that the adjustments reflect the amount unrelated parties would have provided had they adopted such a structure.

The examples in the 2018 HTVI report illustrate these concepts.

Example 1 presents two scenarios. The first demonstrates how the guidance should apply in the event a taxpayer cannot demonstrate that its original valuation was appropriately risk-adjusted or that the *ex post* development was unforeseeable at the time of the initial transfer. The example provides that the adjustment must reflect the *ex ante* risk-adjusted valuation taking into account the additional information. The second scenario illustrates that no adjustment is required because the potential adjustment falls within the exemption provided by item (iii) in paragraph 6.193 of Chapter VI of the OECD TPG, when the difference between the financial projections and actual outcomes does not reduce or increase the compensation for the HTVI by more than 20 percent of the compensation determined at the time of the transaction.

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[17] *See* 2018 HTVI Report at ¶ 17.
[18] *Id*. at ¶ 8.
[19] *Id*. at ¶ 9.
[20] *Id*. at ¶16.
[21] *Id*.

Example 2 demonstrates how a tax administration might consider applying an alternative payment structure, in this case a milestone payment, consistent with paragraph 16 of the 2018 HTVI report, as described above.

The 2018 HTVI report concludes by noting the increased level of certainty that bilateral and multilateral APAs can provide for the transfer of HTVI. The guidance further advises that, in the event application of the HTVI approach leads to double taxation, tax administrations should provide broad access to the MAP process under the applicable tax treaty.[22]

Observations on 2018 HTVI report

The final HTVI guidance provides tax administrations with a powerful tool, because it does not provide any mechanism requiring tax administrations to be held to the same standards as taxpayers when assigning probabilities to uncertain events, including providing evidence that every possible risk outcome has been considered and a probability measure assigned to it. Similarly, the examples in the 2018 HTVI report do not provide guidance that would help make HTVI determinations on the part of tax administrations more objective, for example by showing in detail how *ex ante* probabilities are to be adjusted based on *ex post* evidence. Finally, the guidance continues to sanction changing the form of a transaction with relative ease, even though such a change in form may change the contractually agreed upon risks of the parties.

The HTVI implementation guidance will require taxpayers to prepare fairly detailed and extensive documentation documenting of the risks that were considered and how those risks were weighted in arriving at the price for a transaction. Taxpayers may also want to consider adopting forms of payment that will adjust with changes in circumstances or price adjustment clauses to make it more likely that they will fall within the HTVI 20 percent safe harbor. Finally, in light of the guidance, taxpayers may want to consider entering into an APA, because many tax administrations will forgo the possibility of HTVI adjustments in the context of an APA.

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France publishes decree on new transfer pricing documentation requirements

The French government on June 29, 2018, issued a decree that provides comprehensive guidance on its transfer pricing documentation requirements, applicable for fiscal years that begin on or after January 1, 2018.

The new decree, together with the Finance Bill 2018 approved on December 30, 2017, generally aligns the French transfer pricing documentation requirements with the guidance resulting from the OECD's final report on BEPS action 13. However, the decree introduces some additional – and burdensome – requirements.

The entities in France that are subject to the transfer pricing documentation requirements remain unchanged:

[22] *See* 2018 HTVI Report at ¶¶ 34-39.

- Entities with statutory net sales or gross assets of EUR 400 million and above;
- Entities directly or indirectly owned at more than 50 percent by an entity with statutory net sales or gross assets of EUR 400 million and above;
- Entities that directly or indirectly own more than 50 percent of an entity with statutory net sales or gross assets of EUR 400 million and above; or
- Entities in a French tax consolidated group if a least one member of the tax unity is required to prepare transfer pricing documentation.

The documentation must include all items listed by the OECD in BEPS action 13. French documentation requirements follow the master file/local file approach.

However, the new decree included additional requirements, discussed below.

Format requirements

The new decree requires that a complete documentation report must be provided in an electronic format. Moreover, tables containing financial information (for example, volumes of intercompany transactions, financial data used in the economic analyses, etc.) must be provided in a format that would allow the French tax authorities to check the calculations performed, sort and filter data, and in general make any type of calculations.

The decree provides the format that must be used for some tables. For example, intragroup transactions must be summarized in a table presenting transactions by categories and showing the amounts, the names of the related parties, their roles, and the ISO 3166 codes of their tax jurisdictions. Taxpayers may be familiar with this format, because it closely resembles the format of the transfer pricing form they currently send to the French tax authorities within six months of the deadline for filing the corporate income tax return.

Throughout the documentation report, information must be grouped under specific titles. The master file must have five sections: organizational structure, overview of the group's activities, intangible assets, financial intragroup activities, and financial and the group's tax situation. The local file must have three sections: entity in France, related-party transactions, and financial information.

Additional content and differences with BEPS action 13 requirements

Under the new French documentation rules, the master file must contain information on R&D activities subcontracted to unrelated parties. The guidance under BEPS action 13 does not systematically request this information.

The master file also must include details on the providers of the main intragroup service transactions (including R&D services) regarding specifically employees, equipment, financial resources, and logistics.

For the local file, the decree provides a materiality threshold of EUR 100,000 per type of transactions (for example, provision of services, receipt of services, sales, purchases, etc.). This is the same materiality threshold applicable for the transfer pricing form companies currently send to the French tax authorities within six months of the deadline for filing the corporate income tax return.

The new decree adds a requirement to the effect that the local file must identify the statutory accounts impacted by the intragroup transactions. This requirement will be particularly time consuming for taxpayers.

Comments

The decree is a missed opportunity for the French government to fully align French documentation requirements with the proposed OECD documentation format. Some format requirements – such as the requirement for specific sections in the master file and local file, or the format of certain tables – will create additional work for taxpayers, without providing any value added to the French tax authorities. Moreover, noncompliance with some of the format requirements (for example, the provision of tables in a spreadsheet-based electronic format) and additional content requirements not specifically requested by OECD BEPS action 13 (such as the list of French statutory accounts affected by transfer pricing) will trigger penalties for incomplete documentation, once the French tax authorities have given taxpayers 30 days to comply with a request for information during a tax audit.

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Hong Kong passes BEPS and transfer pricing laws

Hong Kong's Legislative Council on 4 July 2018 passed the Inland Revenue (Amendment) (No. 6) Bill 2017, which entered into force on 13 July following the signature by the Chief Executive and publication in the official gazette. The passage of the Amendment Bill completes the long-awaited codification of Hong Kong's transfer pricing rules, and affirms Hong Kong's commitment to implement the guidance issued under the OECD's base erosion and profit shifting (BEPS) initiative.

The Amendment Bill has been amended since the draft that was issued in December 2017, with a number of amendments made through the Bills Committee Stage, in response to comments received on the original draft. The Amendment Bill will not be the last word on Hong Kong's transfer pricing regulations – the Report of the Bills Committee identified several areas for which the Inland Revenue Department (IRD) will issue further guidance through Departmental Interpretation and Practice Notes (DIPN)[23]. These are expected to be issued in the coming months.

The comments below focus on the key changes made to the original draft, as well as important points that businesses should be aware of as they consider the implications of the new rules and plan for future regulatory compliance.

Transfer pricing regulatory framework

The new law codifies Hong Kong's transfer pricing regulations for the first time, and requires that those regulations be interpreted in a way that ensures consistency with the OECD transfer pricing guidelines, specifically the 2017 version of the guidelines and the 2017 model tax treaty, which incorporate the changes following the BEPS initiatives.

Hong Kong will adopt the three-tier documentation framework proposed in BEPS Action 13, bringing formal transfer pricing documentation regulations to Hong Kong for the first time. Certain domestic related-party transactions will not be subject to the transfer pricing regulations, and fewer companies will need to prepare documentation than was originally expected due to a relaxation of the exemption threshold introduced during the Bills Committee Stage, discussed below.

Through adoption of the OECD guidelines, important concepts that were introduced following the BEPS project, such as the alignment of value creation with economic returns, are now part of Hong Kong's transfer pricing framework. In particular, Section 15F requires that entities that perform DEMPE (development, enhancement, maintenance, protection, and exploitation) functions or that deploy DEMPE assets regarding intellectual property (IP) should be entitled to the associated returns from the IP. Taxpayers will need to consider the implications of this concept in situations where contractual obligations may not be entirely aligned with economic value creation. Specifically, taxpayers should determine whether transactions have been delineated appropriately before preparing Hong Kong transfer pricing documentation.

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[23] DIPNs are issued by the IRD to provide interpretation and guidance in relation to various tax related issues, and are not legally binding.

The Bills Committee confirmed that the new regulations will not change the territorial source principle of taxation. Taxpayers should first compute income and profits on an arm's length basis, and then apply the territorial source principle to determine if such income or profits arise in or are derived from Hong Kong. The IRD will provide more guidance in a DIPN.

Transfer pricing documentation

The introduction of formal Hong Kong transfer pricing documentation regulations has long been expected. Implementing documentation guidelines in line with BEPS action 13 ensures consistency with their international obligations for many taxpayers.

The thresholds for preparing documentation have changed since the draft bill was issued, largely in response to concerns from taxpayers and lawmakers about creating excessive compliance obligations. This has been measured against Hong Kong's intention to maintain a credible and reasonable system that does not raise concerns from the international community regarding Hong Kong's commitment to the BEPS initiative.

Taxpayers will be exempt from the documentation requirements – preparing a master file and a local file – if they meet the following conditions:

Exemption based on size of the business		
Total revenue	<=HKD 400 million	Enterprises are exempt from the master and local file requirements if they satisfy two of the three conditions. It is estimated that 1,390 Hong Kong companies will be required to prepare documentation based on their size.
Total assets	<=HKD 300 million	
Employees (average)	<=100 employees	
Exemption based on value of related-party transactions[24]		
Transfers of property (other than financial assets and intangibles)	<=HKD 220 million	If a transaction type is below the threshold for the accounting period, a local file will not be required for that category of transactions.
Transactions of financial assets	<=HKD 110 million	
Transfers of intangibles	<=HKD 110 million	
Any other transactions	<=HKD 44 million	

The contents of the master file and local file remain unchanged from the draft bill, and are consistent with BEPS action 13. The deadline for preparing the local file and master file has been extended from six to nine months after the accounting year-end, and is aligned with the tax return filing deadline. Experience from the first year of documentation in other jurisdictions shows that this additional time will be essential for the first couple of years, especially for companies that have never before prepared transfer pricing documentation.

Other matters of interest include:

- The local and master files will be submitted only upon request by the IRD. However, taxpayers are required to retain the documentation for seven years. The IRD will conduct desk audits and reviews to ensure compliance;
- Penalties ranging from HKD 50,000 to HKD 100,000 will apply to taxpayers that do not prepare the documentation on time; and
- The information gathered by the IRD may be provided to other tax authorities, although the IRD has emphasized that it will exchange only information that is foreseeably relevant to the other jurisdictions, and will not provide information as part of another authority's "fishing expedition."

Country-by-country (CbC) reporting

Hong Kong resident ultimate parent companies of multinational enterprises with consolidated revenue over HKD 6.8 billion in the previous year, or Hong Kong entities that are nominated as surrogate filing entities, will be required to

[24] "Specified domestic transactions" are excluded when considering exemption based on value of related-party transactions, and need not be analyzed in the Local File.

prepare and submit a CbC report to the IRD. Penalties will apply for non-submission, including a HKD 50,000 – HKD 100,000 penalty, plus a daily fine of HKD 500.

Domestic transactions

The Amendment Bill has been amended through the Bills Committee Stage to exempt "specified" domestic related-party transactions from the transfer pricing rules as well as from documentation requirements. The changes provide that a transaction may not be considered to confer any potential Hong Kong tax advantage if it satisfies the following three conditions:

- The transaction meets the domestic nature test, that is, it's a transaction made or imposed in connection with the two parties' trade, profession, or business carried on in Hong Kong, or the transaction is connected with one of the parties' trade, profession, or business, and the other party is a Hong Kong tax resident;
- There is no actual tax difference as a result of the arrangement, meaning that each person's income (loss) is chargeable (allowable) for Hong Kong tax purposes, and no tax concession or exemption applies to any income (loss); or the "non-business loan test" is met, whereby money is lent other than in the ordinary course of a money lending or intragroup financing business; and
- The main purpose, or one of the main purposes, of the transaction is not to utilize any tax loss for tax avoidance purpose.

While the exemption is fairly broad, it is possible that certain domestic transactions may still fall within the scope of the transfer pricing regulations. Accordingly, Hong Kong taxpayers should determine whether their related-party arrangements satisfy all the tests outlined above. The IRD will issue further guidance under a DIPN.

New TP rules related to intellectual property (IP)

The introduction of the OECD's DEMPE framework for evaluating the economic ownership of IP brings Hong Kong in line with the latest global standard. Under Section 15F of the bill, When a Hong Kong taxpayer performs the DEMPE functions or contributes DEMPE assets, but legal ownership of the IP is held by a non-Hong Kong entity, the IP-related income is deemed to be a taxable receipt of the Hong Kong taxpayer.

The IRD will provide more information in a DIPN, and has deferred the commencement date by 12 months to year of assessment 2019/20 to allow taxpayers time to prepare.

Permanent establishments

The bill requires that the Authorized OECD Approach (AOA) be used to attribute income and profits to Hong Kong permanent establishments (PEs) according to the separate enterprise principle. The Bills Committee specifically commented that the impact of the AOA on financial institutions was a large part of why implementation has been delayed by 12 months, to year of assessment 2019/20.

- Schedule 17G introduces the meaning of a PE in Hong Kong, with different definitions for countries that have entered into an income tax treaty with Hong Kong and those that have not. The PE definition for non-treaty countries generally follows the recommendations of BEPS action 7, whereas that for treaty countries follows the PE articles of existing Hong Kong income tax treaties.
- The AOA gives the IRD the power to assess a Hong Kong branch of a foreign corporation for the income attributed to the branch as if it were a distinct and separate entity. In the past, when a PE in Hong Kong had not been explicitly compensated, the AOA would allow more income to be attributed to that PE. With the application of the territorial source rules, those onshore-sourced profits related to the PE's operations in Hong Kong will be chargeable to Hong Kong tax. In other words, the application of the AOA in conjunction with the source rules may result in more profits of the entity being subject to tax in Hong Kong.
- The IRD will issue a DIPN with further guidance for taxpayers; we anticipate that this guidance will be similar to that issued in other jurisdictions.

Advance pricing arrangements (APAs)

The Amendment Bill codifies the APA regime into the Inland Revenue Ordinance, and provides for unilateral, bilateral, and multilateral APAs. The IRD will be allowed to charge fees for an APA application based on the hourly rates of the IRD officers involved, subject to a cap of HKD 500,000.

Observations

This is the first time Hong Kong has introduced transfer pricing regulations and documentation requirements, and signals that Hong Kong is committed to implementing the minimum standards under the BEPS initiatives. Hong Kong is expected to continue to focus on transfer pricing in the future.

Taxpayers may consider the following actions:

- Reviewing the key related-party transactions that may be subject to the new transfer pricing regulations and documentation requirements, and ensuring that any transactions that may be considered specified domestic transactions are supported by documentation;
- Maintaining contemporaneous documentation (such as transfer pricing policies, intercompany agreements, etc.) to defend the group's transfer pricing position;
- Preparing a gap analysis of the information previously gathered or prepared to support the new transfer pricing and documentation requirements; and
- Monitor the issuance of IRD guidance through DIPNs on some key issues, such as specified domestic transactions, the interaction of the new transfer pricing rules with Hong Kong's territorial source principle, and the deeming provision on IP-related income.

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Germany publishes new guidance on cost sharing arrangements

Germany's Federal Ministry of Finance on 5 July released a circular that adopts the arm's length standard for the examination of cost sharing arrangements (CCAs) and incorporates by reference the principles of Chapter VIII of the OECD's transfer pricing guidelines.

The new circular repeals a prior circular, dated 30 December 1999, and applies to new agreements entered into after 31 December 2018. The previous circular will continue to apply to existing agreements until 31 December 2019.

Both the old and the new circulars deal with CCAs, agreements whereby business enterprises agree to share the contributions and risks involved in the joint development of intangibles, tangible assets, or services, with the understanding that those assets are expected to create benefits for the participants.

The new circular does not make drastic changes to the guidance regarding CCAs, because the previous circular did not contradict the OECD transfer pricing guidelines in principle. By incorporating the recently updated OECD transfer pricing guidelines, the new circular reflects the general development of the international tax environment.

Key change

Under the old circular, CCA participants were only allowed to bill the CCA for their services at cost (although in practice this rule was not applied strictly).

Under the OECD transfer pricing guidelines, on the other hand, these services are generally valued at arm's length (typically with a surcharge rather than at cost). However, the guidance also allows reimbursements for contributions at cost under specific circumstances (see Paragraph 8.27 of the OECD transfer pricing guidelines).

The 5 July circular now stipulates that “contributions must be valued at arm’s length prices,” which at first glance seems to contradict the OECD guidance, which in principle does not rule out allocations at cost. The language in the new circular should probably be understood to mean “arm’s length” in the sense the OECD guidelines interpret the term. That is, if the OECD guidance classifies an allocation at cost as arm’s length, the cost value should be deemed arm’s length under the 5 July circular.

Practical considerations

For planning purposes, the following information should be taken into account:

- The CCA rules require that participants come together for a common benefit, and that all participants provide services; a small participation in the provision of services is sufficient in principle, as long as there is an expectation of a benefit to the participants. The repealed circular also required that the participants have similar interests; the OECD guidance (which the new circular adopts) requires only a common expectation of benefit, and is thus broader. However, from the OECD’s point of view, effective “control” of the pool is also required, as is the proportionate management of risks and the ability to bear risks.
- The repealed circular contained helpful information on the application of accounting regulations and the selection of GAAP, which is now no longer (officially) applicable.
- The former circular denied the deduction of operating expenses if the contract contained serious defects. This regulation, which is now no longer applicable, is likely to have been rendered moot by the Fiscal High Court’s recent case law holding that income tax treaties take precedence over domestic formal requirements. Under the OECD guidance, the contract is also the starting point of the examination and can be recharacterized or ignored and replaced, depending on the level of accurate reflection of the circumstances of the case.
- The OECD guidance points out that management of the pool itself can be a functionally important contribution (see Paragraph 8.31 of the transfer pricing guidelines), which should require a corresponding remuneration or a higher share of future benefits.
- An important aspect is the influence of the discussion regarding hard-to-value intangibles (HTVI), which also has an effect here. The repealed circular authorized pricing adjustments triggered by changes in economic conditions. The HTVI framework of Chapter VI of the OECD transfer pricing guidelines, including the implementation guidance released June 21 by the OECD, appears to go further by authorizing pricing adjustments triggered in certain cases merely by an ex-post result (after risk resolution) “too far” from its asserted ex-ante average. In addition, certain changes in economic conditions that were not reasonably foreseeable at the time of the transaction may be excused from the HTVI framework (provided the taxpayer can establish the unforeseeable nature of the change in condition), which in certain cases could potentially have been subject to pricing adjustments under the circular.

The new circular provides a good opportunity for taxpayers to review existing CCA structures, which should be updated, if necessary, to reflect the modern international tax framework.

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IRS issues Transfer Pricing Examination Process to replace Transfer Pricing Roadmap

The IRS’s Treaty and Transfer Pricing Operations of the Large Business and International (LB&I) division on June 29 released the Transfer Pricing Examination Process (TPEP) to replace the Transfer Pricing Audit Roadmap that was previously issued on February 14, 2014. The TPEP is a guide for IRS agents on audit steps, best practices, and helpful references when auditing transfer pricing issues. The TPEP will be shared with the taxpayers at the start of any transfer pricing examination.
URL: https://www.irs.gov/pub/irs-utl/P5300.pdf

The TPEP provides more comprehensive audit steps than the Roadmap, and a list of tools for auditing transfer pricing examinations.

Discussion

The TPEP acknowledges that transfer pricing examinations are "resource intensive for both the IRS and taxpayers" and that "if the facts of the case show that the taxpayer's results fall within an appropriate arm's length range, then our resources should be applied elsewhere. Likewise, teams should continually assess opportunities for issue resolution with taxpayers during the examination process."

Similar to the Roadmap, the TPEP provides examination teams, in particular IRS persons involved in the audit of transfer pricing issues, a guide to audit techniques to assist with the planning, execution, and resolution of transfer pricing examinations consistent with Publication 5125, *the Large Business & International (LB&I) Examination Process (LEP)*.

For each of the transfer pricing examination phases, the TPEP provides detailed audit steps to be considered, tools that may be used, other guidance and materials, including materials in the Internal Revenue Manual, Internal Revenue Forms and Instructions, outside resources for business financial analytics, and best practices in auditing transfer pricing. The audit steps, tools, and other guidance and materials in the TPEP are more comprehensive than those listed in the Roadmap.

Notable differences between Roadmap and TPEP

The TPEP removes the language in the Roadmap that states that "transfer pricing cases are usually won and lost on the facts."

Unlike the Roadmap, which states that "the objective in a transfer pricing audit is to determine a reasonable result under the facts and circumstances of any given case," the TPEP asserts that the goal of transfer pricing audits is to determine an arm's length result, which may be a range of results, under the facts and circumstances of the case. The TPEP states that "if the facts of the case show that the taxpayer's results fall within an appropriate arm's length range," then the IRS should apply its resources elsewhere.

The TPEP focuses on continual assessment of opportunities for resolution on transfer pricing issues.

The TPEP does not provide an audit timeline, or an estimated timeline of the three phases of a transfer pricing examination. Instead, the exhibits in the TPEP provide general timelines as a guide for different audit phases for a 24-month and a 36-month examination.

The TPEP limits the transfer pricing orientation to selected intercompany transactions in the year(s) under examination rather than all intercompany transactions as stated in the Roadmap. The transfer pricing orientation is a comprehensive presentation by the taxpayer to discuss its transfer pricing transactions, including but not limited to the business operations, worldwide structure, transfer pricing policies, as well as the background, history, rationale, and value drivers related to the transaction.

The TPEP revises the audit steps related to the best method selection process. Previously, the Roadmap guided IRS agents to "begin to formulate the best method analysis to include assessment of taxpayer's selected method." However, the TPEP does not tell the IRS agent "to formulate the best method analysis"; rather, the TPEP only advises the IRS agents to "evaluate the taxpayer's selection of the best method."

The TPEP provides that, as a "best practice," an Acknowledgement of Facts (AOF) IDR should be issued for all transfer pricing issues, whether potentially agreed or unagreed.

The TPEP reaffirms that the IRS requires 365 days to remain on the statute of limitations for taxpayers to protest a case at Appeals, as required by Internal Revenue Manual 25.6.22.2.1 (02-09-2018), *Assessment*, and Phase 2 of the Appeals Judicial Approach and Culture (AJAC) Project effective September 2, 2014.

The TPEP lists the following audit steps in separate sections, which were previously embedded in the body of the Roadmap:

- Developing a detailed Preliminary Working Hypothesis, meeting with the taxpayer regarding the team's working hypothesis(es) and preliminary findings, and reassessing/adjusting the working hypothesis as needed;
- IRC Section 6662(e) Documentation Request, whereby IRS agents are no longer required to issue the mandatory 6662(e) transfer pricing IDR and the IRS agents have to follow the Interim Instructions on Issuance of Mandatory Transfer Pricing IDR in LB&I Examinations, a memorandum dated January 12, 2018, for all LB&I employees;
  URL: https://www.irs.gov/businesses/corporations/interim-instructions-on-issuance-of-mandatory-transfer-pricing-information-document-request-idr-in-lbi-examinations
- The Review of IRC Section 6662(e) Response, which guides the IRS agent to consider whether the 6662(e) documentation satisfies the requirement of Treas. Reg. §1.6662-6(d)(2)(iii), whether the documentation addresses the controlled transactions, and whether the conclusions reached can be considered reasonable;
- Penalties consideration; and
- The Appeals process.

The TPEP added the following sections that were not included in the Roadmap:

- Collaboration with Advance Pricing Mutual Agreement Program;
- Analyze the country-by-country (CbC) report and provide the taxpayer an opportunity to voluntarily walk through the issues listed on the report;
- US Competent Authority request and Competent Authority request concerning US-initiated actions; and
- Sections that should be included in the Notice of Proposed Adjustment and Economist Report.

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Norway's tax authorities issue annual transfer pricing report, and auditor general reports on authorities' approach to transfer pricing

The Norwegian Tax Authorities (NTA) recently published its annual report on transfer pricing, which includes a summary of the transfer pricing issues worked on during 2017, a recap of the NTA's current transfer pricing organizational structure and priorities, and an explanation of the new organizational structure that will take effect from 1 January 2019.

Subsequently, the Office of the Auditor General delivered its report on the NTA's approach to transfer pricing to the Norwegian Parliament on 5 June 2018. The report found that historic transfer pricing audits have generated average tax adjustments of approximately NOK 10 billion per year, but raised a number of criticisms regarding how the tax authorities have approached this area and included recommendations for improvements in the future.

Transfer pricing report for 2017

Audits: The NTA is handling significantly fewer cases than in prior years (see the table below).

	2015		2016		2017	
Status	**Number of cases**	**Calculated amount**	**Number of cases**	**Calculated amount**	**Number of cases**	**Calculated amount**
Final decision in the year and not appealed	36	2,851	31	1,556	18	919
Appealed/active	51	6,396	19	3,367	15	3,732
Total	**87**	**9,247**	**50**	**4,923**	**33**	**4,651**
All figures are in million NOK.						

Intangibles-related issues and thin capitalization were the two largest subject areas by value, accounting for approximately NOK 2 billion and NOK 1 billion of the total, respectively. The largest number of cases related to allocations to permanent establishments (PEs), purchase of goods (primarily transactional net margin method (TNMM) cases), and the charging of services.

The NTA established a valuation group in 2016 that continued its role in 2017 developing centralized competence in valuations within the NTA. The group worked on 25 cases in 2017, 13 of which were transfer pricing-related:

	Total number of cases		Of which the following are transfer pricing cases		
Type of property	**Number**	**%**	**Number**	**% of TP cases**	**% of all cases in that property type**
Company valuation	11	44%	4	31%	36%
Intangible property	5	20%	5	38%	100%
Fixed assets	7	28%	3	23%	43%
Other / financial assets	2	8%	1	8%	50%
Total	**25**	**100%**	**13**	**100%**	**52%**

MAPs and APAs: Norway introduced a general bilateral APA regime in 2015, and there is a specific MAP/APA unit within the NTA.

There were six new MAP cases in 2017, compared to 14 in 2016. Eleven cases were finalized in 2017, plus two that were resolved via a domestic solution in one of the countries involved. Clearly, cases are being resolved at a slower rate than the rate at which they are being initiated.

At the beginning of 2017 there were four APA cases outstanding (three on Article 9 issues and one on Article 7); two of the Article 9 APAs were finalized during 2017. There were no new APAs requests during the year.

Case law: Norwegian courts heard seven transfer pricing cases in 2017, five of which were final cases. These covered a range of topics: interest; recharacterization; use of the TNMM method; brand management costs; wet gas pricing; marketing costs; and whether documentation was insufficient so that the statute of limitations for tax audits could be overturned. The NTA won, or at least won partially, in all cases.

The number of transfer pricing cases in 2017 is similar to that in previous years.

Resources: The number of NTA employees dedicated to transfer pricing issues increased by about 10 percent in 2017:

Resources for TP work	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Number of full-time equivalents	87	88	98	89	87	96

Organizational structure: In 2014 the NTA established a “risk project” for transfer pricing. The purpose of this project was to determine the group’s structure and focus areas. This project will continue through the end of 2018. Effective 1 January 2019, the NTA will be organized under a new structure. Transfer pricing, the Oil Taxation Office, and the MAP/APA unit will be three separate subdivisions within the large business division. The transfer pricing subdivision will be managed out of Stavanger, with three offices in or around the Oslo area.

Auditor General's investigation of tax authorities' control of transfer pricing

The Norwegian Parliament's Finance Committee in a report from 2015/2016 recognized that the pricing of intercompany transactions (including financing) is often tax motivated, but was also cognizant of the importance of balancing the requirements of maintaining tax revenue with keeping Norway a competitive environment for international investors. As a result, the Office of the Auditor General was tasked with evaluating the NTA's work on the transfer pricing of cross-border transactions.

In its recently released report, the Auditor General had five principal findings:

- The NTA's audits in the period from 2009 to 2016 (that is, since transfer pricing documentation regulations were introduced in Norway) resulted in approx. NOK 79 billion in tax adjustments, with an average of NOK 10 billion in adjustments per year;
- The NTA initiated transfer pricing audits on only a small portion of taxpayers with controlled transactions, ranging between 0.6 percent (30 cases) and 2.2 percent (110 cases) of all relevant groups. Furthermore, the number of new audits started each year was at the same level in 2016 as in 2009, despite the NTA's increased resources over time. The NTA has worked since 2014 to develop a Risk Management System for the selection of audit cases, but the system has not yet been finalized, so case selection is up to individual NTA case workers;
- It takes a long time to complete an audit, and the time frames are unclear. Thirteen of 32 cases took more than 1,000 days to finalize. Additionally, the tax authorities were reticent in some cases to set deadlines and adhere to them, and a number of taxpayers broke statutory deadlines;
- The NTA does not use the penalty options available to it effectively. The NTA imposed penalty tax in only 16 out of 304 transfer pricing cases in the period from 2009 to 2016, and the internal guidance was to use these penalties only in limited circumstances. Starting in 2017, a NOK 50,000 penalty may be imposed when information is not submitted to the NTA on time, but this has generally not been used, because the NTA considers this figure low and not relevant for transfer pricing cases; and
- The Ministry of Finance has not obtained information about the tax effect of the transfer pricing audits that have been undertaken.

The Auditor General had the following recommendations:

- Evaluate whether the audit of transfer pricing is given sufficient priority;
- Contribute to a national system for better risk management and selection of transfer pricing cases for audit;
- Evaluate whether the penalties are sufficient for transfer pricing;
- Clarify what a company's responsibilities are regarding providing sufficing information within specified deadlines; and
- Ensure that there is a good overview of the final effect of the audits on the tax base.

Comments

The NTA's annual report shows that the number of cases that are appealed and those where a final decision has been entered are approximately equal in number. However, the majority of decisions (in terms of amounts) have been appealed. This, together with the falling number of audit cases from 2015 to 2017, suggests that the NTA is focusing its efforts on more complex cases that are, not surprisingly, then appealed. This is consistent with our experience that the NTA is focusing more effort on such complex cases, and especially those including Norwegian parented groups.

There is a net increase in MAP cases, which is likely to lead to an increase in processing time. It is notable that no new APA requests were filed in 2017. It is still early days for the APA instrument in Norway, so we would expect more groups to utilize this avenue in the future, particularly as they adapt to the transfer pricing changes introduced by the BEPS Action Plan. Furthermore, the NTA encourages APAs, and it is reasonable to expect that APA applications will be given priority.

We anticipate some increase in requests for transfer pricing documentation as a result of the Auditor General's criticism of the NTA, and potentially increased use of penalties. The Auditor General particularly criticized the NTA's risk management system. The NTA has had a related-party disclosure form in place since Norway's transfer pricing documentation rules were introduced, will now receive country-by-country reports, and is introducing SAF-T requirements in 2020. We would therefore expect improvements in the risk management system, with knock-on effects for the level of transfer pricing audits.

The Auditor General also commented on the length of transfer pricing audits. The majority of days during an audit are spent by the NTA processing the case, not waiting for the taxpayer to provide information. The duration of tax audits therefore cannot be pinned on taxpayers; thus, it is unreasonable to think that a "clarification of taxpayers' responsibilities" is the solution.

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Italy issues new measures on implementation of domestic transfer pricing provisions

Italy's Ministry of Economy and Finance on May 16, 2018, issued a decree and regulations that implement domestic transfer pricing provisions.

Background

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

- A draft decree providing guidelines to address arm's length issues in compliance with the OECD transfer pricing guidelines; and
- A draft of the regulations implementing the newly introduced unilateral corresponding adjustment procedure (Art. 31 *quater* of Decree 600/1973).

Interested parties were encouraged to provide comments on the two issues, which were then published on the ministry's website on April 5.

The ministry held a meeting in Rome on May 8 with ministry representatives and some of the parties that had participated in the consultation, where proposals and remarks were reviewed and discussed. On May 16, the final version of both the decree and the regulations were issued, incorporating some of the comments made by the participants and implementing the new rules.

Decree addressing implementation of arm's length principle

The decree contains measures aimed at implementing the OECD's transfer pricing guidelines (TPGs) within the Italian tax system. The main aspects addressed by the decree can be summarized as follows:

- The 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 TPGs;
- A description of the applicable transfer pricing methods and the criteria for selecting the most appropriate one, according to the TPGs;
- A precise definition of the concept of "arm's length range," which had been missing from the Italian regulations, as the "range of values resulting from the financial indicator 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";

- Confirmation that, in cases in which 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 back within the range. The new provision represents a step forward in providing taxpayers with more precise guidance; however, it misses an opportunity to clarify to which point in the range the adjustment should bring the tested transaction/party's value/profitability to render it arm's length;
- A brand new provision addressing remuneration for intercompany low-value-adding services, stating that a transaction will be acknowledged to be at arm's length if the value of the service is determined by adding a profit margin of 5 percent to the sum of all direct and indirect costs related to the supply of the service. Services can be classified as low-value-adding if:
    - The services qualify as supportive services only;
    - The services are not part of the multinational group's core business; and
    - The provision of the services does not require the use of unique or highly valuable intangible assets.

Finally, the decree states that transfer pricing documentation prepared according to Italian standards must be considered suitable when it provides the auditors with the data and information necessary to analyze the transfer prices applied, regardless of:

- Whether or not the transfer pricing method or the selection of transactions or comparable subjects differ from those the tax authorities would rather select; and
- Any omissions or partial inaccuracies that are not likely to compromise the auditors' analysis.

Regulations on unilateral corresponding adjustments

On May 30, 2018, regulations were issued implementing the provisions of Article 31-*quater* of Decree 600/1973 (recently introduced by Law Decree 50/2017), which provides 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 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 now be possible, not only by means of a mutual agreement procedure as provided under either the EU Arbitration Convention (Convention 90/436/EC of 23 July 1990), or the applicable income tax treaty, but also through a specific request for a unilateral "correlative adjustment" to be filed by the Italian taxpayer with the domestic competent authority.

However, such a unilateral adjustment, which might allow the taxpayer to recover the excess taxes paid in Italy, can be claimed only in case of a transfer pricing adjustment that meets the following conditions:

- The primary adjustment must comply with the arm's length principle;
- The state that made the primary adjustment must have signed 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 to the Revenue Agency a certificate issued by the foreign state confirming that that is the case.

The regulations indicate how to file the application for a unilateral correlative adjustment, 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 (subject to the possible suspension mentioned). If the request is accepted, the Revenue Agency will determine the taxpayer's right to obtain a downward adjustment in its taxable base (which would entail the possibility for the taxpayer to obtain a reimbursement or a tax credit) equal to the amount of the primary adjustment.

If the Italian tax authorities reject a unilateral adjustment request, and 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.

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