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Saudi Arabia releases draft transfer pricing regulations

The Kingdom of Saudi Arabia's (KSA's) General Authority of Zakat and Tax (GAZT) released on 10 December 2018 a draft of the long-anticipated transfer pricing regulations. The regulations would apply for accounting periods ending on or after 31 December 2018 and introduce new compliance obligations, including a transfer pricing disclosure form that would need to be filed within 120 days of the end of the accounting period.
URL: https://www.gazt.gov.sa/sites/default/files/2018-12/180911_BYLAWS_TP_ENG_PCV_v.012%20%2812.05%29.pdf

A consultation on the draft regulations ran until 9 January 2019, and the bylaws are expected to become final at the end of February.

Taxpayers with December 2018 year-ends will have until April 2019 to manage a number of compliance obligations and new guidance, including an extensive definition of control as set out below.

The guidelines generally are consistent with the OECD 2017 transfer pricing guidelines and the key features are outlined below.
URL: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#.WWTj14TyuVM

Scope of the regulations: The regulations would apply to all taxpayers and cover any transaction between related persons or persons under common control. A person for these purposes would require legal personality and includes partnerships, representative offices, and permanent establishments (PEs). Intragroup transactions of less than SAR 6 million (approximately USD 2 million) would be exempt from the master file and local file requirements but not from the obligation to prepare a disclosure form, which would benefit start-ups, primarily domestic groups, and smaller enterprises.

Definition of related persons

The draft regulations provide a detailed definition of related persons, which is broadly consistent with OECD standards. Two persons would be considered related if they are under common control or if one has effective control over the other. The definition of control would not correspond to that used in other areas of KSA tax law.

The definition of multinational enterprise in the context of country-by-country (CbC) reporting would require there to be entities in two or more tax jurisdictions (or one entity and a PE). This indicates that certain domestic transactions may not fall within the scope of the regulations, but further details are expected during the course of the consultation. The control criterion of 25 percent of borrowings under guarantee would have direct relevance in Saudi Arabia due to the prevalence of guarantees (mainly outbound) on borrowings to support operating companies. In addition, there are other criteria for control that are transaction-based rather than structural that would be important to understand when assessing whether the transfer pricing regulations apply.

Definition of "under common control"

Two or more persons would be deemed to be under common control if a person or related persons, either individually or jointly:

- Controls directly or indirectly 50 percent or more of such persons. The draft regulations provide a specific definition of control in the context of partnerships, capital companies, and agencies; or
- Can directly or indirectly control the business decisions of, or otherwise have effective control over the person.

Effective control

A person or persons would have effective control of another person when they have the ability to control the business decisions of that person. This would include the ability to:

- Conclude an agreement to provide management services to the company or otherwise effectively perform the functions of management;
- Act as trustee (manager) of the other person under a trust arrangement; or
- Directly or indirectly control the composition of 50 percent or more of the board of directors, or have the right to appoint or dismiss the management representatives of the other person.

Effective control also would exist when 50 percent or more of a person's business activities depend on transactions with another person(s), or those person(s) have:

- The legal or *de facto* right to receive, directly or indirectly, 50 percent or more of the other person's profits;
- Directly or indirectly provided loans to the person with a total outstanding balance of 50 percent or more of the funds necessary for the borrower's business; or

- Issued guarantees to cover 25 percent of the person's total borrowings.

There also would be effective control when:

- A person is related to a person who, directly or indirectly, holds 50 percent or more of a person or participates, directly or indirectly, in the management of that person;
- A person is, or related persons jointly or severally are, the principal or supplier of a person under an exclusive agency, distributorship arrangement, or any such similar contract for the sale of goods, services, or rights, and that person is a dependent agent of the principal and is prohibited from entering into another similar agency, a distributorship arrangement, or any such similar arrangement for the duration of the person's relationship with the principal;
- In the case of a nonresident person or related persons, when a substantial portion of the business activities of a resident person depends on transactions with the nonresident person or related persons, and the resident person's business activities depend on rights in intangible property exclusively granted to the latter directly or indirectly by the nonresident person or related persons; or
- The person is, or related persons, jointly or severally, are able to control the business decisions of the other person in any other way as evidenced by the facts and circumstances.

Disclosure form: The draft regulations indicate that taxpayers would be required to file an annual disclosure form with the income tax return within 120 days after the financial year-end. The disclosure form would have to include:

- General information on the parties to the controlled transaction, such as legal names, locations, etc.;
- Information about any business restructurings;
- Details of legal and beneficial owners;
- Total revenue, total expenses, and amount of net profit/(loss);
- Type and nature of the relationship between the parties to the controlled transaction;
- Details of the nature of the business activities of the parties to the controlled transaction;
- Aggregate amounts of consideration, the nature of the receipt or income or the nature of the payment or expenditure;
- The transfer pricing method applied;
- A statement certifying whether the taxpayer has entered into controlled transactions without monetary or nonmonetary consideration; and
- Confirmation of the existence of transfer pricing documentation, including the master file and local file.

CbC reporting: CbC reporting and notification requirements would apply to groups with turnover exceeding SAR 3.2 billion (approximately USD 850 million). A master file and local file also would be required, in line with OECD BEPS Action 13. Pure Zakat entities are exempt from the requirement to file a master file, a local file, and a disclosure form, but not from the CbC reporting requirement.
URL: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en

Choice of transfer pricing method: The choice of transfer pricing method is aligned with OECD guidance, with five prescribed methods: comparable uncontrolled price, resale price, cost plus, transactional net margin, and transactional profit split. Commentary in the guidelines states that one method per transaction would be sufficient, as opposed to adopting multiple methods.

Comparability: When assessing comparability of transactions in support of arm's length pricing, the draft regulations clarify that:

- The OECD's five factors of comparability (characteristics of property/services, functions/assets/risks, contractual terms, economic circumstances and business strategies) should be applied, together with an additional sixth factor "any other economically relevant terms." This is a helpful addition and in general, there is considerable deference to actual facts and circumstances throughout the draft regulations;
- There would be flexibility for both the GAZT and businesses to select the point in the range that suits the facts and circumstances of the case; and
- Neither the tax authorities nor taxpayers should rely on "secret comparables," with a view to encouraging greater transparency between the tax authorities and business.

Interaction with PE regulations: There was an initial concern that the current PE regulations in Saudi Arabia providing for deemed profit margins as high as 80% for certain activities would be at odds with the OECD principles. The first draft of the regulations helpfully confirms that the arm's length principle should apply to PEs.

Comments

While the disclosure submission is an additional administrative burden on businesses that will require some attention, the draft rules' confirmation of PE attributions and deference to facts and circumstances are welcome. It is important for taxpayers to focus on the new rules now, before the rush to comply that will likely ensue in April.

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OECD policy note has broad implications for US multinationals

The 127-member OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) released on January 29 a policy note (Addressing the Tax Challenges of the Digitalisation of the Economy) that describes the ongoing work of the Inclusive Framework focused on redesigning the global international tax architecture in response to rapid changes to business models around the world.
URL: http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

The policy note emphasizes that countries have not committed to any specific outcomes and remain free to agree or disagree as the work moves forward. The Inclusive Framework operates on a consensus basis, which generally means that all member countries will have to agree to an approach before it can be finalized by the 2020 target date. Achieving this consensus will be challenging, but not impossible.

The Inclusive Framework is expected to release an issue paper providing further details around February 11. In addition to requesting comments on the issue paper, they will hold a two-day public consultation on March 13 and 14. Following the public consultation, the Inclusive Framework will further describe the path forward and will report that in June at the G-20 Finance Ministers' meeting in Japan, with the hope for a final proposal being issued on schedule in 2020.

Two pillars of consensus

Inclusive Framework members have agreed to examine proposals involving two "pillars" that could form the basis for consensus. One pillar addresses nexus and allocation issues focused on giving market jurisdictions greater rights to assert tax nexus and to be allocated a share of a multinational's taxable income. During an OECD webcast that occurred in connection with the issuance of the policy note, OECD officials explained that the concepts to be discussed under the first pillar would be (i) the preexisting UK proposals around significant digital presence and income allocation based on users; (ii) a US proposal to identify valuable marketing intangibles (for all taxpayers) and assign the return on those intangibles to the market jurisdictions; and (iii) a proposal from developing countries focused on a permanent establishment in the case of a "significant economic presence." Importantly, the note indicates that "[i]n all cases, these proposals would lead to solutions that go beyond the arm's length principle. They also go beyond the limitations on taxing rights determined by reference to a physical presence generally accepted as another corner stone of the current rules."

Significantly, the policy note further observes that:

> The Inclusive Framework recognises that what is proposed may affect not only a small group of highly digitalised businesses but could affect a much wider group of enterprises with cross border business operations, for instance those with marketing intangible profits but limited risk distribution structures in market jurisdictions. Further technical work on the design considerations of the proposals would be required, taking into consideration potential scope limitations, business line segmentation, profit determination and allocation, as well as nexus and treaty considerations.

According to the policy note, the efforts may include more administrable, simplified approaches to these issues, including the use of withholding taxes. Furthermore, it notes both the importance of avoiding double taxation and the need for effective dispute resolution procedures.

The second pillar would address the continued risk of profit-shifting to entities subject to no or very low taxation through the development of two interrelated rules: an income inclusion rule (similar to the US GILTI rules, although possibly designed on a country-by-country basis) and a tax on base-eroding payments when the country to which the payments are made does not enact its own income inclusion rule.

Considerations for US taxpayers

Taxpayers should be aware that this work, *which will likely affect all businesses with cross-border operations*, requires a great degree of additional technical attention and is moving very quickly. Companies may wish to follow the technical work closely.

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Uruguay issues resolution on CbC reporting requirements

Uruguay's tax authorities on 4 January issued a resolution that confirms filing and notification deadlines regarding country-by-country (CbC) reporting. Resolution 94/2019 supplements legislation enacted in January 2017 and Decree 353/018, published in October 2018.

The legislation allows the Uruguayan tax authorities to request CbC reports for fiscal years commencing from 1 January 2017 from domestic taxpayers that are members of large multinational entity (MNE) groups.

The filing requirement applies to Uruguayan taxpayers that are either the ultimate parent entity of a large MNE group or a subsidiary of a foreign-parented group.

However, an exception applies to local subsidiaries when the group files a CbC report in a country that has a competent authority arrangement in force with Uruguay that allows for the exchange of CbC reports for the relevant fiscal year. When the exception does not apply and the local subsidiary is required to file a CbC report in Uruguay, Resolution 94/2019 provides that such reports will not be exchanged with tax authorities in other jurisdictions.

The law also allows the tax authorities to request the submission of a master file by taxpayers that belong to MNE groups, irrespective of their size.

A large MNE group is defined as one with total consolidated income in the year prior to that to which the CbC report relates of at least EUR 750 million or its equivalent in another currency.

The decree also sets out the notification requirements for a local subsidiary of a large MNE group. They must provide the following to the tax authorities annually:

- Name and country of tax residence of the entity that will file the CbC report for the group;
- Name and country of tax residence of the group's ultimate parent entity; and
- Names of other group members resident in Uruguay.

Resolution 94/2019 clarifies that the notification must be submitted via the tax authorities' website during the group's relevant fiscal year, and that annual notifications are required, even if there are no changes during the year. As an exception, the notification deadline for fiscal years ending between 31 December 2017 and 28 February 2019 is 31 March 2019.

Decree 353/018 specified that the CbC report and master file were to be filed within 12 months of the relevant fiscal year-end, subject to further regulations to be issued by the tax authorities. Because the necessary filing procedures were not implemented before December 2018, Resolution 94/2019 granted an extension for filing the CbC report for fiscal years ending between 31 December 2017 and 30 November 2018 to 15 months after the year end. The CbC report must be submitted in xml format, with the standard codification.

The resolution does not include a deadline or specific requirement for filing the master file. Further regulations may be issued, or the tax authorities may request the master file from individual taxpayers on a case-by-case basis.

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Canadian taxpayer wins landmark transfer pricing case

On September 26, 2018, the Tax Court of Canada ruled in favor of Cameco Corporation (Cameco) in a landmark transfer pricing case. The case involved Cameco's 2003, 2005, and 2006 taxation years. On October 26, 2018, the Canada Revenue Agency (CRA) filed an appeal with the Federal Court of Appeal regarding the decision.

Overview

Cameco is the world's largest publicly traded uranium company and is based in Canada. The transfer pricing arrangement at issue involved Cameco Europe (CEL), a subsidiary of Cameco based in Switzerland. CEL purchased uranium from Cameco and third parties pursuant to a number of long-term contracts. In general terms, intercompany purchases from Cameco were priced based on the published long-term price for uranium at the time the contracts were concluded (as is common in the industry). CEL subsequently entered into sales contracts for the uranium purchased from Cameco and the third parties. Due to increases in uranium prices, CEL generated significant profits.

CRA reassessed Cameco on the basis that CEL's profits should have been realized by Cameco. The CRA's case was based on three key arguments:

- First, CRA asserted that the transfer pricing arrangement was a sham. CRA argued that Cameco transferred its uranium trading business to CEL on paper, but in reality, all important functions and strategic decisions for the uranium trading business continued to be performed by Cameco.
- Second, CRA asserted that the arrangement was not commercially rational and should be recharacterized. CRA argued that Cameco negotiated valuable uranium contracts and allowed CEL to enter into those contracts even though Cameco knew the contracts would give rise to an economic windfall.

- Third, CRA argued that the arrangement should be subject to a price adjustment given that an arm's length party would not agree to terms or conditions that result in any income being earned by CEL.

The court held that the element of deceit required for a sham was not present. Further, a parent entity providing a subsidiary a business opportunity is not commercially irrational. Lastly, the court held that the third-party uranium purchase contracts negotiated by Cameco and entered into by CEL did not have intrinsic economic value at the time they were entered into, and that the prices charged by Cameco to CEL for uranium delivered were well within the arm's length range of prices.

Background

The decision describes the following key facts:

- CEL[1] is a wholly owned Swiss subsidiary of Cameco.
- Cameco Inc. (Cameco US) is a wholly owned US subsidiary of Cameco.
- In 1999, the Cameco group was restructured, with Cameco as a miner and producer of uranium, CEL as a uranium trader, and Cameco US as a distributor of uranium to end customers.
- Over a number of years, Cameco pursued negotiations in order to secure certain uranium purchase arrangements.[2] Starting in 1999, CEL entered into uranium purchase agreements (UPAs) with arm's length third parties (Third Party UPAs) and CEL also entered into long-term UPAs with Cameco (Cameco UPA).
- Thereafter, Cameco US purchased uranium from CEL and sold it to third-party customers. Cameco US did not hold inventory and only took flash title to the uranium it sold to third-party customers. The terms of the sale of uranium from CEL to Cameco US mirrored the terms of the sale of uranium from Cameco US to the customers, except that the price was 2 percent lower such that Cameco US earned a 2 percent resale margin.
- CEL entered into an intercompany services agreement with Cameco whereby Cameco agreed to provide various services including uranium contract administration, legal, accounting, and other functions.
- CEL had one senior employee up to 2006, with extensive experience in the uranium industry, and hired a second employee at that time. CEL's employee(s) regularly attended sales meetings held by Cameco US.
- After 2002, there was a significant increase in the market price of uranium. The pricing of the Third-Party UPAs and Cameco UPA allowed CEL to benefit from the increasing market price of uranium.

Key points of judgement

Sham: The court resoundingly rejected CRA's argument that the arrangements involving CEL were a sham, stating that CRA's position "reflects a fundamental misunderstanding of the concept of sham." In reaching this decision, the court reviewed the jurisprudence on the concept of sham as originally formulated in *Snook v. London & West Riding Investments Ltd.*, [1967] 1 All E.R. 518, as well as Canadian cases dealing with the sham doctrine. From this, the court concludes that for a transaction to be a sham the facts (assumed or proven) must establish that the parties to the transaction presented their legal rights and obligations differently from what they know to be true. On the basis of the facts, the court concluded that there was "…no evidence to suggest that the written terms and conditions of the many contracts…do not reflect the true intentions of the parties to those transactions, or that the contracts presented the resulting transactions in a manner different from what the parties knew the transactions to be."

Notably, the court also concluded, "The arrangements created by the contracts were not a façade but were the legal foundation of the implementation of the Appellants tax plan." The court then stated, "…a tax motivation does not transform the arrangements among [the parties] into a sham."

In arguing sham, CRA had asserted that Cameco employees were performing various services for Cameco's account, and that the control and essential functions of the uranium trading business were undertaken by Cameco rather than CEL. In support of its position, CRA had argued that some of the contracts that CEL entered into actually were concluded by employees of Cameco rather than employees of CEL. The court found that there was no evidence to support a conclusion that Cameco was performing services for its own account rather than for the benefit of CEL. The court stated that a corporation may undertake activities through its own employees or through independent

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[1] Cameco originally established a Luxembourg entity that had a branch in Switzerland. This Swiss branch was subsequently transferred to CEL. In this article, the Luxembourg entity and CEL are collectively referred to as CEL.
[2] These negotiations had commenced before CEL was established.

contractors acting on its behalf. The court held that the examples provided by CRA on this point were insignificant and did not support a conclusion that Cameco routinely concluded contracts on behalf of CEL (or the conclusion that the overall arrangement was a sham and that the business of CEL should be considered to be the business of Cameco).

CRA also argued that the overall arrangement was a deliberate deception of CRA "because the Appellant was doing everything." In making this argument, CRA relied on the fact that Cameco continued to play an important role in various activities and the decision-making process among the parties was collaborative rather than adversarial. On this point, the court held that there was "nothing unusual about the way in which the Cameco Group operated," noting that it is common for administrative functions to be centralized and shared, for there to be commercial integration across the enterprise, and for the parent to provide cooperation and coordination among the entities.

Consequently, the court found that the element of deceit required for a sham was not present.

Recharacterization: The *Cameco* case is the first case that involves judicial interpretation of the recharacterization provisions of the Income Tax Act (ITA).

The transfer pricing recharacterization rule in paragraphs 247(2)(b) and (d) of the ITA may apply when a two-prong test is satisfied:

1. The transaction or series would not have been entered into by arm's length parties; and
2. The transaction or series can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

The court stated that the assumption underlying the recharacterization provision is that arm's length parties would not have entered into the transaction or series on any terms or conditions, but that there is an alternative transaction that arm's length parties would enter into. While the court determined that the recharacterization provision was not applicable, it is notable that the court stated that CRA can assume the existence of an alternative transaction and the taxpayer must then overcome the assumption. It also is notable that the court stated that in evaluating the "purpose" when there is a series of transactions, one must consider the purpose of the overall series, and not each individual transaction in the series (unlike the approach that is used in evaluating purpose under the general anti-avoidance rule).

In evaluating the applicability of the recharacterization provision, the court also stated that while the purpose of section 247 of the ITA is to implement the arm's length principle, "Parliament has chosen text that is quite different from the text…of the Model Convention." As a result, the court directs that the evaluation must be based on the text chosen by Parliament, and reiterates the principle established by the Supreme Court of Canada in *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52, [2012] 3 S.C.R. 3 that the OECD transfer pricing guidelines are not controlling as if a Canadian statute.

In applying the first test, the court instructs that the question to address is whether the transaction or series would have been entered into by arm's length persons acting in a commercially rational manner. If a transaction is commercially rational, then it is reasonable to assume that arm's length parties would enter into it. The court considered whether it was commercially rational for Cameco to allow CEL to enter into the Third-Party UPAs. The court accepted the view of Cameco's expert that "Any entity would be willing to give up a business opportunity as long as they are fairly compensated…." The court also stated that "There is nothing exceptional, unusual or inappropriate about the Appellant's decision to incorporate [CEL] and have [CEL] execute the [Third-Party UPAs]," and suggested that such behavior is a core function of a parent of a multinational enterprise. As such, the Third-Party UPAs entered into by CEL did not meet the first test. The court similarly found that Cameco's sale of uranium to CEL did not meet the first test, citing that the terms and conditions of the Cameco UPA generally were consistent with practices in the uranium industry.

Under the second test, the court found that the primary purpose of the Third-Party UPAs was to save tax, whereas there was a bona fide profit-earning primary purpose in respect of the Cameco UPA.

Ultimately, the recharacterization rules did not apply to the transactions and series at issue, given that the first test was not satisfied.

Price adjustment: Having concluded that the arrangements between Cameco and CEL were neither a sham nor subject to recharacterization, the court evaluated whether the pricing of such arrangement was arm's length.

A price adjustment under paragraph 247(2)(a) and (c) of the ITA will apply to a transfer price when the price that would have been paid in the same circumstances between persons dealing at arm's length differs from the price actually applied to the transaction or series. A price adjustment does not permit for the recasting of the arrangements made between the participants (*e.g.*, as in the case of a recharacterization), except to the limited extent necessary to properly price the transaction or series by reference to objective benchmarks.

CRA argued that Cameco knew the Third-Party UPAs it allowed CEL to enter into were valuable business opportunities and that Cameco should not have allowed CEL to earn any more than a routine distributor's return. However, the court found that the Third-Party UPAs were entered into with third parties and reflected "a market determined value." While there was no doubt the Third-Party UPAs afforded CEL an opportunity, the court accepted the view of Cameco's expert that the economic benefit of participating in the Third-Party UPAs was negligible at the time the parties executed the contracts – whether the opportunity had positive or negative value depended on uncertain future events. On this basis, the court said that there was no evidence to warrant a transfer pricing adjustment with respect to the Third-Party UPAs.

CRA took the position that the profit earned by CEL from the Third-Party UPAs and Cameco UPA should be attributed to Cameco because it performed all the critical functions that earned the profit, including market forecasting and research services. CRA's expert reports suggested that CEL's income should be based on a cost plus or resale minus approach, shifting all of the income attributable to uranium price movement to Cameco.

The court held that the evidence established that the services provided by Cameco to CEL in support of its purchase and sale activities were routine commercially available services utilizing non-proprietary information. Further, CEL contracted Cameco to perform certain services and, under Canadian law, there is no distinction between a corporation carrying on activities using its own employees versus using independent contractors. The court also rejected the contention that Cameco unilaterally made all decisions regarding the purchase and sale of CEL's uranium. CEL's workforce had sufficient expertise and was involved in making key decisions regarding such purchases and sales.

Finally, the court considered the consistency between the legal contracts and economic substance of the arrangement. The court found that CEL had contractually assumed price risk by entering into the Third-Party UPAs and Cameco UPA.

In respect of the Cameco UPA, the court accepted an application of the comparable uncontrolled price method in determining that the prices charged by Cameco to CEL for uranium delivered were well within the arm's length range of prices.

Consequently, the court held that there was no evidence warranting a price adjustment for the Third-Party UPAs or the Cameco UPA.

Appeal

On October 26, 2018, the CRA filed an appeal with the Federal Court of Appeal regarding the Tax Court of Canada decision. The CRA did not appeal the Tax Court of Canada's decision that sham does not apply.

Takeaways

The issues decided in the *Cameco* case are not confined to any specific area of transfer pricing and have broad implications. The key principles affirmed by the court in the *Cameco* decision include:

- The traditional principles of what constitutes a sham continue to apply. If the contractual arrangements reflect the underlying transactions and the intention of the parties, the arrangement should not be considered a sham.
- A transaction should not be subject to recharacterization if it is commercially rational. If it is commercially rational, the transfer pricing issue is simply the determination of the correct price.
- If a series of transactions is undertaken primarily for business purposes, it should not be subject to recharacterization. Unlike the test applied pursuant to the general anti-avoidance rule, the entire series should

not be tainted if one aspect is undertaken primarily for tax purposes, provided the overall series is undertaken to achieve a business purpose.

Further, in evaluating transfer prices:

- Absent a recharacterization, the transfer pricing analysis must focus on the actual transactions and respect the contractual arrangements.
- A parent of a multinational group is allowed to provide a business opportunity to a subsidiary.
- Corporations bearing contractual risk will be subject to the resulting profit or loss – it is not critical that the corporation directly employ the individuals that manage the risk.
- There is a strong preference for traditional transaction transfer pricing methods that directly test the price of the transactions actually undertaken. Use of methods that effectively rewrite the transaction or determine the income that would be realized if the taxpayer had entered into different contractual arrangements are to be avoided.
- Transfer pricing analyses should, to the extent possible, be based on objective evidence. Speculation about what parties might have known should be avoided.

In light of the strong focus on contractual arrangements (which might not align with the approach in other jurisdictions), multinationals should review their transfer pricing positions and consider whether all significant intercompany transactions are covered by appropriate legal documentation and whether the relevant parties to such transactions are acting in accordance with the legal arrangements.

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Germany issues new administrative guidance on deviations from arm's length principle in specific restructuring situations

On 6 December 2018, Germany's Federal Ministry of Finance released a two-page circular with new administrative guidance that allows German taxpayers to justify a deviation from the arm's length principle under specific circumstances.

The scope of the circular is limited to cases in which an intercompany transaction within the EU is directly related to a "financial recovery measure" taken by the taxpayer to support the corporate group or a specific company within that group. If a German taxpayer can prove that a financial recovery measure is required and that there is a possibility of a successful recovery, then the taxpayer can justify a deviation from the arm's length principle with regard to its cross-border intercompany transactions (that are related to the financial recovery measure within the EU). In those cases, the German tax authorities will not impose an income adjustment despite the non-arm's length pricing.

This circular is the first administrative reaction in Germany to the European Court of Justice's (ECJ's) 31 May 2018 ruling in the Hornbach-Baumarkt case (C 382/16, Hornbach-Baumarkt). The court had ruled that one of the core German transfer pricing laws (sec. 1 of the German Foreign Tax Code (FTC)) must include an option for taxpayers to justify potential deviations from the arm's length principle with "economic reasons." Otherwise, income adjustments based on sec. 1. FTC might conflict with the EU's freedom of establishment.

The court also clarified that "economic reasons" may include reasons that are based on the shareholder relationships between the related parties. This comment caused considerable uncertainty among taxpayers and tax advisors in Germany, because the arm's length principle so far has been understood to require taxpayers to disregard any shareholder relationships when determining appropriate transfer prices.

With the issuance of the new circular, the German tax authorities have now reacted to this court ruling. In their response, they appear to suggest a narrow interpretation of the court's comments by linking them only to financial recovery measures.

Background: Concerns regarding the German FTC's compliance with European law

Germany's transfer pricing laws are manifold. Sec. 1 FTC generally applies to all types of intercompany transactions, but is limited to cross-border situations. Other regulations, such as sec. 8 para. 3 of the German Corporate Tax Code (CTC) also apply to domestic transactions within Germany, but those regulations do not cover all kinds of intercompany transactions. For example, the pricing of domestic transactions such as the granting of guarantees or the provision of services by the parent company to a subsidiary are generally not covered by these regulations. Hence, intercompany transactions (such as free-of-charge intercompany downstream guarantees or services) between related parties in a cross-border context may receive less favorable legal treatment than otherwise identical transactions in a domestic context.

In the EU context (group parent company in Germany and subsidiary in another EU country), such unequal treatment of domestic transactions and cross-border transactions can give rise to concerns regarding German law's compliance with the EU's fundamental freedoms, in particular the freedom of establishment. The freedom of establishment allows all EU companies to establish subsidiaries, branches, and agencies in any other EU member state (without discriminatory treatment compared to domestic subsidiaries, branches, or agencies).

The ECJ addressed those concerns in its 31 May 2018 judgement. The ECJ concluded that a restriction of the freedom of establishment may be appropriate if it is necessary to ensure an appropriate allocation of taxation rights among countries. In this respect, sec. 1 FTC was found not to be in fundamental conflict with European law. However, the court found that compliance with European fundamental laws is ensured only if a taxpayer has a chance to demonstrate that its deviation from the arm's length principle is due to "economic reasons" (that is, non-tax reasons).

Implications of the ECJ decision

The Hornbach-Baumarkt judgment was unclear as to which types of (shareholder-related) "economic reasons" would be accepted by the German tax authorities, and in which cases would these economic reasons justify a deviation from the arm's length principle. Some observers commented that the ruling might effectively downgrade sec. 1 FTC so that it only prevents purely artificial arrangements in the EU context in the future (because "economic reasons" can likely be put forward by taxpayers for all other arrangements).

Commentators also discussed whether extending the scope of sec. 1 FTC (so that it also covers domestic transactions) or of sec. 8 para. 3 CTC (so that it also covers downstream services and financial guarantees) would remove the unequal treatment of domestic transactions and intra-EU transactions, and thus remove any concerns with regard to the EU's freedom of establishment. However, both changes would create major disruptions in German taxation principles and might create significant additional compliance burdens and uncertainty for taxpayers.

Contents of the new circular

The administrative circular issued on 6 December 2018 adopts none of the measures discussed above. Instead of changing any of the tax laws involved, the German Federal Ministry of Finance is taking a relatively quick but small first step to resolve the matter.

The circular's unofficial translation reads as follows:

> *In its ruling of 31 May 2018 in Case C-382/16 "Hornbach-Baumarkt," the European Court of Justice ruled that a provision such as the one in section 1 FTC must allow a resident taxpayer to prove that conditions have been agreed upon for economic reasons resulting from its position as shareholder of the nonresident company. In the present case, a subsidiary was reliant on the injection of capital to expand its business activities. In such a case, economic reasons could justify the granting of capital by the parent company under non-arm's length conditions.*
>
> *Accordingly, an income adjustment based on section 1, paragraph 1 FTC cannot be imposed if the taxpayer can prove factual, economic reasons that require conditions deviating from the arm's length principle to secure*

the otherwise threatened economic existence of the group of companies as such or the entity affiliated to the taxpayer ("financial recovery measure"). Financial recovery measures are aimed at avoiding over-indebtedness or insolvency, and ensuring the going concern of the related party or group of companies. The taxpayer must provide [firstly] evidence of the requirement for a financial recovery measure [in German "Sanierungsbedürfigkeit"], in particular the need for a financial recovery and [secondly] the possibility of a successful financial recovery [In German "Sanierungsfähigkeit"] with regard to the affiliated entity or group of companies.

In its decision, the ECJ refers to the freedom of establishment; hence, its decision does not apply to cases involving non-EU countries.

Conclusion

With the new administrative circular, the German tax authorities are likely attempting to limit the potential applicability of the court's ruling to a narrow set of situations – financial recovery situations within the EU. Given that the court did not limit the scope of its comments to such cases, commentators expect further administrative or legislative changes and/or further court decisions that hopefully will provide more clarity. It is important to note that the administrative guidance is binding only on the tax authorities, not on taxpayers or the courts.

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Japanese parties announce 2019 tax reform proposals

Japan's ruling coalition – the Liberal Democratic Party (LDP) and the New Komeito Party – approved on 14 December 2018 tax reform proposals that were posted on the LDP's website.
In the area of international tax, the proposals include revisions to the earnings stripping rules and the transfer pricing rules that align with the OECD's base erosion and profit shifting (BEPS) project.

The transfer pricing proposals are discussed below. It should be emphasized that these proposals have not been enacted and could change prior to becoming law.

Transfer pricing

The FY2019 tax reform package is set to make important changes to Japan's transfer pricing rules, taking into consideration the recommendations of the BEPS project and the revised OECD transfer pricing guidelines, which incorporate such recommendations. The revisions are specified to also apply to the law relating to the calculation of profits attributable to permanent establishments. The revisions are proposed to apply to the corporate taxation rules for fiscal years beginning on or after 1 April 2020 and to the (individual) income taxation rules for the 2021 calendar year and thereafter.

Clarification of the definition of intangible assets

The Japanese transfer pricing rules currently do not provide a clear definition of the term "intangible asset." The FY2019 tax reform package proposes that the term "intangible asset" be defined as assets owned by a juridical person (*i.e.*, a legal entity such as a corporation), other than tangible and financial assets such as cash, deposits, and securities, for which consideration would be paid between unrelated parties. For example, a transfer or license of assets between independent parties according to ordinary business terms would qualify.

Revision of methods for calculating arm's length prices

The FY2019 tax reform package also proposes adding a discounted cash flow method for calculating the arm's length price to the Japanese rules on the grounds that the OECD transfer pricing guidelines recognize the usability of discounted cash flow when calculating the price of intangible assets for which no comparable transactions exist.

The addition of the discounted cash flow method also would allow tax examiners to use this method in a presumptive taxation scenario (for example, when a taxpayer has not appropriately responded to tax authority requests for data supporting its transfer pricing).

Introduction of adjustments for transactions of hard-to-value intangibles

The proposed reforms are also set to incorporate the OECD's approach to hard-to-value intangibles (HTVI) into Japanese law. The Japanese rules would apply to "specified intangible assets" that meet the following criteria:

- The assets are unique and have an important value;
- The arm's length price is calculated using forecasts (such as projected future income); and
- The forecasts used are recognized to be uncertain.

Similar to the OECD approach, the Japanese proposal provides that when assessing HTVI-related transactions, the tax authorities would have the power to make adjustments to pricing that was based on forecast information, when the actual outcome differs from the forecast, after taking into account factors such as the likelihood of the result and the grounds that caused the difference. The Japanese rules would also incorporate a threshold for adjustments whereby no adjustment would be made if the difference between the forecast and the actual result does not exceed 20 percent.

Adjustments would not be made if the taxpayer can provide certain supporting evidence upon request from a tax examiner. Specifically:

Evidence supporting the forecasts:

- Details of the basis for the forecasts used in the calculation of the arm's length price; and
- Evidence supporting the conclusion that the cause of deviation from the forecast was a disaster or similar event, which was difficult to predict at the time of pricing the transaction, or that the arm's length price was appropriately calculated taking the probability of the event into consideration.

Evidence supporting the outcome:

- Documentation demonstrating that the difference between projected figures and actual results (the projected and actual income) for five years from the date of initial recognition of revenues received from unrelated parties relevant to the asset does not exceed 20 percent.

It is not yet clear whether an exception will also be included for transactions covered by a bilateral or multilateral advance pricing arrangement (APA) when the reforms are implemented.

Extension of statute of limitations

The proposed reforms extend the statutory limitation period for reassessments relating to transfer pricing from six to seven years.

Formalization of the interquartile range

The interquartile range concept is finally set to be formalized in Japanese transfer pricing law. This is proposed to be implemented through the introduction of a "quartile method" adjustment for transactions priced based on the profit margin of comparable transactions, when sufficient quantitative data to make appropriate comparability adjustments is not available.

Comments

Taken as a whole, the proposed changes to the transfer pricing law represent a package of amendments necessary to implement the OECD's approach to HTVIs and to arm the tax authorities with appropriate tools to make after-the-fact adjustments to consideration paid for such assets.

In comparison to the OECD's approach, the definition of "specified intangible asset" differs slightly from the OECD's HTVI definition; for example, an asset with unique and important value compared to an asset for which no reliable comparable exists. However, as a practical matter, the scope of this criteria of the definition may be similar, and both the Japanese and OECD definitions seem to cover a broad range of intangible assets. Similarly, while the definition of "specified intangible asset" requires forecasts to be shown to be uncertain, this may be a reasonably low threshold given the inherently uncertain nature of financial forecasts. In addition, it may be difficult for taxpayers to provide evidence showing that the reason for the deviation was difficult to predict or taken into account at the time of the transaction, unless significant efforts to produce such evidence are made at the time of the transaction.

The tax reform proposal suggests a relatively narrow definition of the difficult-to-predict events that are exempted from adjustments by making reference to "disaster(s) or similar events," whereas the OECD also mentions, for example, the removal of a key product from the market, a key asset malfunction, and a technological breakthrough by a competitor, in relation to such events. On this basis, the proposed Japanese HTVI rules may have broader application than the OECD approach.

The additional proposed changes provide the framework for the tax authorities to effectively apply the new HTVI rules. For example, the extension of the statute of limitations may bring assets that will not generate income for long periods within the scope of potential adjustments. The interquartile range, while already commonly used by taxpayers in practice (in transfer pricing documentation), may represent a relaxation of otherwise strict comparability criteria necessary to make transfer pricing adjustments, thus expanding the potential for adjustments.

Finally, it is important to note that the OECD approach contains an exception to after-the-fact adjustments when the taxpayer has entered into a bilateral or multilateral APA. The proposed changes to the Japanese law do not specify such an exception. However, the exception may be included in an interpretative circular, or may apply at a practical level, given that transactions covered by an APA generally may not be adjusted by a tax authority, provided certain conditions are met. There may also be arguments that documents produced during the process of obtaining an APA may constitute evidence that the taxpayer was using the best available information at the time of the transaction. In this regard, the introduction of the HTVI rules into Japanese law may result in a further increase in the use of APAs by multinational companies.

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Botswana introduces transfer pricing legislation

Botswana's parliament on 12 December 2018 approved a bill that introduces transfer pricing legislation and a limitation on interest deductibility based on earnings before interest, tax depreciation and amortization (EBITDA). The Income Tax (Amendment) Bill 2018 also amends the International Financial Services Centre (IFSC) regime.

Botswana subsequently announced that the transfer pricing provisions will enter into effect on 1 July 2019.

The bill's key transfer pricing features are discussed below.

Transfer pricing

The transfer pricing legislation will apply to transactions between connected persons within and outside Botswana. If a transaction between connected persons is not consistent with the arm's length principle, the income that would have accrued in a comparable transaction that was consistent with the arm's length principle will be included in the recipient's taxable income. There is no provision for a corresponding adjustment to the deduction available to the payer.

The Minister of Finance and Economic Development must issue regulations to determine whether the conditions of a transaction are consistent with the arm's length principle and the method of calculation of any required adjustments.

When a Botswana resident taxpayer acquires a new or used asset from a connected person that is not resident in Botswana, and the latter had purchased the asset from an independent third party, the Botswana tax authorities will deem the purchase price of the asset to be nil, unless the taxpayer provides a tax invoice issued by the independent third party to the connected nonresident.

Bilateral advance pricing agreements (APAs) will be available provided Botswana has entered into an income tax treaty with the country in which the connected person is resident. Regulations for APAs are awaited.

Details of transfer pricing documentation requirements have yet to be announced by the minister, but documentation must be provided to the Commissioner General on request. Failure to submit the transfer pricing documentation when requested can result in the imposition of penalties of up to BWP 500,000.

Failure to comply with the transfer pricing legislation can result in the imposition of penalties of the greater of 200 percent of the tax that would have been payable had the transaction been conducted at arm's length or a fine of BWP 10,000.

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Colombia announces due dates for transfer pricing filings

Colombia's Ministry of Finance & Public Credit on December 27 published Decree 2442, which establishes the deadlines for filing transfer pricing-related documents corresponding to fiscal year 2018, including the transfer pricing informative return, the master file, the local file, the country-by-country (CbC) report, and the CbC report notification.

Taxpayers subject to the Colombian transfer pricing reporting requirements must file the transfer pricing informative return, the CbC report notification, and the local and master files according to the following schedule:

Last digit of taxpayer's Tax Id	Due Date
0	July 9, 2019
9	July 10, 2019
8	July 11, 2019
7	July 12, 2019
6	July 15, 2019
5	July 16, 2019
4	July 17, 2019
3	July 18, 2019
2	July 19, 2019
1	July 22, 2019

For taxpayers subject to CbC reporting requirements, the due dates for filing the report will be as follows:

Last digit of taxpayer's Tax Id	Due Date
0	December 10, 2019
9	December 11, 2019
8	December 12, 2019
7	December 13, 2019
6	December 16, 2019
5	December 17, 2019
4	December 18, 2019
3	December 19, 2019
2	December 20, 2019
1	December 23, 2019

The decree also imposes various penalties for failure to timely file the informative return and the transfer pricing documentation, and for filing inaccurate information.

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Brazil clarifies transfer pricing method computation

Brazil's Federal Revenue (RFB) published guidance (Normative Ruling (NR 1,870/19)) on 30 January that clarifies the time that taxpayers must calculate the transfer pricing method and the time a transfer pricing adjustment must be included in taxable income for corporate income tax purposes.

NR 1,870/19, which revises a ruling issued in 2012, also makes minor changes to the wording and terminology of the transfer pricing regulations. The new guidance applies from the date of publication.

In determining whether a transaction between related parties is in line with Brazil's transfer pricing rules, a comparison is made between the "tested price" (the price in the relevant transaction) and the comparable price (the "parameter price" based on Brazil's transfer pricing legislation). The following methods are used to determine the comparable price in a transaction: the resale minus profit (PRL) method, the comparable uncontrolled price (CUP) method, the cost plus (CPL) method, and the commodities methods (PCI and PCEX).

The main changes made by NR 1,870/19 can be summarized as follows.

PRL method

The tested price must be determined at the time of effective consumption, taking into account the cost of initial inventory and fiscal year purchases, minus the cost of closing inventory (*i.e.*, the cost of goods sold).

For purposes of the PRL method computation and determining the average parameter price (the comparable price), exports should be excluded from the resale transaction pool. Eventual price adjustments for international freight and insurance are not excluded from the cost of goods sold for purposes of the gross profitability analysis.

PIC and CPL methods

The comparable price must be determined in the calendar year in which an import is made, even though any transfer pricing adjustment will be made at the time the imported good, service, or right is consumed. The same procedure applies when the CPL method is utilized.

It was not clear under the 2012 NR whether certain purchases and sales between third parties in which the buyer or seller were related to the Brazilian entity could be used for the PIC analysis. NR 1,870/19 clarifies that third-party transactions can be used regardless of whether the parties are related to the Brazilian entity.

Commodities methods (PCI and PCEX)

The transfer pricing methods for intercompany imports and exports of commodities are tested using the PCI (imports) and PECEX (exports), with the prices defined based on the average commodity exchange price for the relevant item on the date of the transaction, on a transaction-by-transaction basis.

Previously, products subject to the PCI and PCEX methods were: (a) those listed in Annex I (commodities and harmonized fiscal codes) of the 2012 NR, as long as prices are negotiated on one of the stock markets listed in annex II (list of authorized stock markets), or determined by the institutions listed in annex III (list of autorized research sectorial insitutions); or (b) products that were listed only on the stock markets in Annex II. NR 1,870 removes the applicability of the PCI and PCEX methods if products are listed only on the stock markets in Annex II.

Impact on interest on net equity (INE)

As an alternative to a dividend distribution, a Brazilian company generally is allowed to make INE payments to its shareholders based on the application of the public long-term interest rate to the Brazilian company's net equity. The INE payments are deductible for corporate income tax purposes, subject to certain limitations.

Rules already in place address the impact that an adjustment for the excess of tested prices over comparable prices has on the determination of a company's net equity for purposes of calculating the INE. NR 1,870 clarifies the time at which such an adjustment is to be taken into account, depending on the transfer pricing method adopted. If the excess is calculated using the PCI, PIC, or CPL methods, the adjustment impact will be in relation to the tested price in the fiscal year in which the import transaction concerned takes place. When the PRL is used, the impact will be in relation to the tested price in the fiscal year of consumption.

Margin of difference

NR 1,870/19 changes the basis for calculation of the margin of difference from the tested price to the parameter price, a change that may result in higher transfer pricing adjustments on imports and lower adjustments on exports.

The margin of divergence is a benefit available under all Brazilian transfer pricing methods, under which a transfer pricing adjustment will not be required if the tested price does not exceed the parameter price by more than 5 percent (3 percent for commodity imports/exports when the PCI and PCEX methods are used).