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## IRS issues memorandum on mandatory consultations between LB&I Exam and APMA Program

In a memorandum dated February 19, 2019, the Internal Revenue Service revised Internal Revenue Manual (IRM) 4.61.3 regarding certain examinations involving transfer pricing issues. The memorandum requires collaboration between transfer pricing issue teams and the Advance Pricing and Mutual Agreement (APMA) Program on examinations with the potential to generate transfer pricing adjustments involving a country with which the United States has a double tax treaty. This consultation requirement applies regardless of whether the taxpayer currently has a mutual agreement procedure (MAP) or advance pricing agreement (APA) case in the APMA Program or whether



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APMA has an active relationship with the treaty partner. It also applies to issue teams staffed by Transfer Pricing Practice, Cross Border Activities, or Geographic Compliance Practice Area personnel.

The memorandum applies to transfer pricing examinations of Large Business and International (LB&I) taxpayers[1] opened in the IRS Issue Management System from the date of its issuance. Nevertheless, the memorandum does not preclude consultation on cases opened before it was issued.

The memorandum is consistent with the Transfer Pricing Examination Process (TPEP), released on June 29, 2018, which also requires collaboration with the APMA Program when the transaction involves a treaty country.[2]

The memorandum requires that the issue team consider APMA's relevant treaty background and competent authority experience with the treaty partner and/or transfer pricing issues early in the issue-development process to risk-assess the issue properly. According to the memorandum, such background discussions are designed to help the issue team understand how certain facts and arguments might be best developed and supported, as well as to provide perspective on the history APMA may have with the type of case being pursued, particularly whether in similar situations an adjustment has been withdrawn in whole or in part before or after negotiations have begun.

The memorandum also notes that the issue teams are ultimately responsible for the selection and development of all examination issues and for ensuring that an appropriate degree of independence from the competent authority process is maintained.

An attachment to the memorandum sets forth the procedures that must be followed by LB&I employees for implementing the required consultations between the transfer pricing issue teams and APMA personnel. Of note, the issue team must contact APMA at the beginning of the issue team's review. During the consultation, APMA and the transfer pricing issue team are required to discuss the intercompany transactions and issues under review, and APMA is required to share its experience, both generally and as it pertains to the applicable treaty partner. Among other things, the APMA team has been instructed to share its experience with similar cases, presentations of facts, and arguments that can often arise during the competent authority negotiations, and, as appropriate, possible outcomes resulting from the negotiation process.

**Observations**

APMA has extensive experience dealing with transfer pricing issues in the context of negotiations with tax treaty partners in APA and MAP. In addition, APMA, unlike the examination team, can rely on the OECD transfer pricing guidelines when developing a position (if the intercompany transaction involves a treaty partner).[3] APMA may recommend that the examination team modify a transfer pricing adjustment that is under consideration, for example, if APMA considers that the adjustment would be difficult or impossible to sustain in MAP. As a practical matter, it is unclear how much influence APMA will exercise in this regard, given that the issue team is ultimately responsible for the development of the transfer pricing examination.

The memorandum does not indicate whether the results of the consultation will be discussed with the taxpayer or whether any notification will be made to the taxpayer that such consultation has occurred or will occur. However, given the potential benefits of APMA's early involvement during the transfer pricing examination, we recommend that taxpayers proactively discuss the potential involvement of APMA with the issue team during a transfer pricing audit.

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[1] Taxpayers that have assets equal to or greater than $10,000,000, that are required to file Form 5471 or 5472 with their federal income tax returns.
[2] For Deloitte's prior coverage of the TPEP, *see* Global Transfer Pricing Alert 18-022. For a copy of the TPEP, *see* https://www.irs.gov/pub/irs-utl/P5300.pdf.
[3] 2007 GLAM LEXIS 27, GLAM 2007-007 (IRS March 15, 2007). *See also OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris. http://dx.doi.org/10.1787/tpg-2017-en.


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## Peru again extends due date for filing CbC report

The Peruvian tax authority (SUNAT) on March 14 published an administrative regulation that extends in certain cases the deadline to submit the country-by-country (CbC) report corresponding to fiscal years 2017 and 2018.

**SUNAT Resolution**

SUNAT's Resolution No. 054-2019 provides that the due date to submit the informative CbC report – Virtual Form N°3562 – for fiscal years 2017 and 2018 is extended in certain cases.

The deadline for submission is extended to the last business day of the month following the date in which SUNAT publishes on its website a notice to the effect that Peru has approved the evaluation of the standard of confidentiality and security of information required by the Organization for Economic Cooperation and Development (OECD) for the automatic exchange of information. For example, if the notice is published on March 20, the due date is extended to the last business day of April.

The due date extension for the FY 2017 CbC report applies only to taxpayers domiciled in Peru that are members of a multinational group whose parent entity is not domiciled in Peru and that are included exclusively in Article 116 (b)(2) of the Income Tax Law Regulations. This article establishes the obligation to file the CbC report by those taxpayers who on the due date for filing the CbC report have a parent company domiciled or resident in a jurisdiction that has entered into an international tax treaty with Peru (or a decision of the Andean Community Commission) that authorizes the exchange of tax information, but does not have a competent authority agreement for the exchange of the CbC report in force.

For FY 2018 CbC reports, the due date extension also applies to taxpayers subject to the provisions of Article 116(b)(1) and (3), which impose an obligation to file the CbC report when the non-domiciled parent company of the multinational group is not obliged to submit CbC report in its domicile or residence jurisdiction, and when a systematic failure in the exchange of tax information exists that has been communicated by SUNAT to the taxpayer domiciled in the country.

SUNAT had previously extended the due date for filing FY 2017 CbC reports to March 2019. For prior coverage, see Global TP Alert 2018-33.
**URL:** https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-18-033-13-november-2018.pdf



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**Entry into force**

The new regulation is effective on the day it was issued.

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## India, United States sign agreement to exchange country-by-country reports

India's Central Board of Direct Taxes on March 27 issued a press release announcing that India and the United States had signed a bilateral agreement for the exchange of country-by-country (CbC) reports.
**URL:**
https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/751/PressRelease_Signing_Inter__India_USA_27_3_19.pdf

The agreement will allow the two countries to exchange automatically CbC reports filed by the ultimate parent entities of multinational enterprises (MNEs) in their respective jurisdictions. The agreement, which pertains to years commencing on or after January 1, 2016, also would render it unnecessary for Indian subsidiaries of US MNEs to file CbC reports in India.

The United States has not issued a similar announcement regarding the signing of the bilateral agreement; however, the IRS updated its web page on the status of the United States' CbC competent authority agreements to reflect that an intergovernmental agreement for the exchange of CbC reports between India and the United States has been signed, and that the bilateral competent authority agreement between the two countries was "in signature process." Importantly, the IRS added a note indicating that local filing "will not be required in India."
**URL:** https://www.irs.gov/businesses/country-by-country-reporting-jurisdiction-status-table

As of February 2019, there were over 2000 bilateral exchange relationships activated by jurisdictions committed to exchanging CbC reports, and the first automatic exchanges of CbC reports took place in June 2018. These include exchanges between the 77 signatories to the CbC Multilateral Competent Authority Agreement, between EU Member States under EU Council Directive 2016/881/EU, and between signatories to bilateral competent authority agreements for exchanges under income tax treaties or Tax Information Exchange Agreements, including 45 bilateral agreements with the United States (including the newly signed India agreement).[4]
**URL:** http://www.oecd.org/ctp/exchange-of-tax-information/CbC-MCAA-Signatories.pdf

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[4] Country-by-country exchange relationships, OECD, http://www.oecd.org/tax/beps/country-by-country-exchange-relationships.htm


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## Swedish tax authority announces position on relationship between transfer pricing documentation and tax penalties

The Swedish tax authority (STA) on December 3, 2018, issued administrative guidance (in Swedish) on the relationship between transfer pricing documentation and tax penalties. While the administrative guidance does not constitute legislation, it illustrates the STA's position on the matter.
**URL:** https://www4.skatteverket.se/rattsligvagledning/373216.html

As a rule, tax penalties are levied on transfer pricing adjustments at a rate of 40 percent of additional tax (or 10 percent of the reduced losses). The STA's view is that having transfer pricing documentation should result in the relief of potential tax penalties by half, if the following requirements are met:

- The taxpayer must submit transfer pricing documentation that fulfills the Swedish content requirements upon the STA's request;
- The documented transfer pricing policy should not deviate significantly from common international transfer pricing standards; and
- The taxpayer must have applied the documented policy and methods in practice.

**Comments**

The administrative guidance reiterates the importance of maintaining contemporaneous transfer pricing documentation, as it could reduce tax penalties in the case of a transfer pricing adjustment. It is therefore recommended that multinationals review their current transfer pricing documentation to ensure compliance with Swedish documentation requirements, and that the documentation reflect the actual conduct of the parties within the group.

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## IRS APMA Program releases Functional Cost Diagnostic Model to evaluate potential reliability of profit splits

The IRS Advance Pricing and Mutual Agreement Program recently released an Excel-based Functional Cost Diagnostic Model (FCDM) to assist in its analysis of whether certain intercompany transactions may be more reliably measured by applying a profit split methodology rather than a one-sided comparable profits method (CPM)/transactional net margin method (TNMM) methodology.

The IRS APMA program has requested that several, but not all, taxpayers currently in the advance pricing agreement (APA) process complete the FCDM. Although the FCDM was issued by the APMA Program, it has the potential to be used by the IRS in transfer pricing examinations pursuant to recent IRS guidance requiring coordination between LB&I and APMA on examinations with the potential to generate transfer pricing adjustments involving a country with which the United States has a double tax treaty (see Memorandum for Large Business and International Division employees from Douglas W. O'Donnell, Interim Guidance on Mandatory Issue Team Consultations with APMA for Examination of Transfer Pricing Issues Involving Treaty Countries, dated Feb. 19, 2019, and the IRS Transfer Pricing Examination Process guidance).
**URL:** https://www.irs.gov/pub/irs-utl/P5300.pdf

Addressing whether the diagnostic tool may be used in the examination process, Jennifer Best, director (treaty and transfer pricing operations), IRS Large Business and International Division, said April 2 at the Tax Executives Institute's midyear conference in Washington that "the diagnostic tool was really designed or motivated for a specific batch of cases – certain types of cases – that are in our APA inventory, and it lends itself better to the voluntary


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process than the exam process," Best said. "It may be used in the exam context, if appropriate, but it was really designed for the APA context."[5]

The IRS's use of the FCDM may impact foreign multinational groups that have historically applied CPM/TNMM to evaluate the transfer prices with their US distributors. The FCDM may also impact US multinational groups if the IRS APMA program uses it in MAP cases to evaluate the reliability of profit split-based transfer pricing adjustments issued by foreign tax authorities.

The FCDM was issued in response to the OECD BEPS initiative, as well as positions taken by US and foreign tax authorities in prior transfer pricing examinations and MAP and APA cases, and references the OECD 2017 transfer pricing guidelines. The IRS memorandum issued describes the reason for the FCDM as follows:

> APMA is requesting that the taxpayer complete this model so that APMA can better understand the controlled taxpayers' contributions to the proposed covered transactions, including the respective contributions each controlled taxpayer makes to the exercise of control over the economically significant risks surrounding the proposed covered transactions. Based upon its past direct experience with the taxpayer's prior APAs and its general understanding of the taxpayer's business operations, APMA believes it is necessary to consider whether the arm's length values of the respective contributions to the proposed covered transactions might be more reliably measured by comparing them to one another than by benchmarking returns for the functions a single taxpayer in the proposed covered group performs, the assets it employs, and the risks it assumes.

The FCDM requires the identification, organization, and analysis of "functional" costs, that is, costs incurred by controlled taxpayers within the scope of the proposed APA covered transactions. It also requires taxpayers to analyze the economic value of the contributions associated with the activity for which the functional costs are incurred. The IRS notes that many of the functional costs will be incurred by the controlled taxpayers in performing "routine" functions and that the economic value of such contributions is measurable by reference to benchmarks obtained from comparable uncontrolled transactions.

The FCDM next requires taxpayers to consider which controlled taxpayer(s) incur functional costs having an economic value that would not be measured reliably by referring to benchmarks and that are expected, ex ante, to last beyond a single accounting period. The IRS does not specify what functional costs may meet this description and notes that they will necessarily be specific to the business operations of the proposed covered group and the scope of the proposed covered transactions.

The FCDM directs taxpayers to the 2017 OECD guidelines for guidance on what factors the taxpayer should consider to identify these functional costs. The model addresses these functional costs differently from how it addresses benchmarkable functional costs. The FCDM then accumulates these costs and capitalizes them according to standard formulas and techniques and based on certain assumptions (such as the useful life of a "unique and valuable" contribution) and calculates a pro forma split of residual profits (losses) based on relative accumulated and capitalized functional costs.

The FCDM documentation contains the following important note:

> The fact that the model computes a pro forma residual profit (loss) split does not imply APMA has thereby concluded already that the transactional profit split method – or, more specifically, the residual profit split method ("RPSM") – is the "most appropriate method" for the taxpayer's proposed covered transactions under the OECD Guidelines. APMA will make that determination based upon its review of the facts it obtains through due diligence, including discussions with the taxpayer about the application of this diagnostic model, and the standards set forth in the OECD Guidelines.

This note is significant in that it demonstrates the IRS APMA Program is evaluating these issues in a reasoned and taxpayer-specific basis. Since not every taxpayer in the APA process has received the request to complete the FCDM, it can be inferred that one-sided CPM/TNMM benchmarking methodologies may continue to be the most common transfer pricing method agreed to in APAs (according to the 2018 Announcement and Report Concerning Advance

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[5] "IRS Examiners May Use APMA Diagnostic Tool in Some Cases," Worldwide Tax Daily, 2019 WTD 64-1 (April 3, 2019).


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Pricing Agreements, which covers calendar year 2017, the CPM/TNMM was used for 87 percent of transfers of tangible and intangible property, while all other methods combined accounted for the other 13 percent of such transactions. Most services transactions (86 percent) also used the CPM/TNMM). Nevertheless, it is advisable for taxpayers to evaluate the potential impact of the FCDM as part of their transfer pricing compliance processes.

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## Belgium tax authorities publish guidance on application of transfer pricing documentation penalty regime

The Belgian tax authorities published additional guidance on the application of the transfer pricing documentation penalty regime on February 8, 2019. The guidance was published as a circular (2019/C/14) that will be an addendum to an existing circular (2017/C/56) on the Belgian transfer pricing reporting requirements.

### Background

A Belgian entity that is part of a multinational group that exceeds certain thresholds is required to prepare and file transfer pricing documentation (the country-by-country (CbC) report, the CbC notification form, the master file form, and the local file form).

The penalty regime included in the Belgian tax code sanctions failure to file timely comprehensive and accurate documentation. The amount of the penalty depends on both the nature and the ranking of the violation.

### Nature and ranking of violation

The new circular provides a three-tiered penalty regime whereby penalties may be imposed depending on the nature of the offense:

- For offenses due to circumstances beyond the taxpayer’s control, no penalty is imposed.
- For offenses that do not involve a wilful intent to harm or to commit fraud, no penalty is imposed for the first offense; for the second violation, penalties that range from EUR 1,250 to EUR 25,000 can be imposed, depending on the ranking of the violation.
- For offenses that do involve a wilful intent to harm or to commit fraud, a penalty of EUR 12,500 can be imposed for the first offense. For subsequent violations, a penalty of EUR 25,000 can be imposed.

The circular confirms that, to determine the ranking of an offense, only offenses of the same nature must be taken into consideration. In addition, whether a violation should be considered as a subsequent violation depends on whether the tax authorities informed the taxpayer that a previous violation of the same nature had already been identified. In this respect, the tax authorities must give notice of the identification of a violation and the related penalty. The circular includes additional examples relating to this guidance.


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**Date of violation**

The circular states that the exact date of an offense depends on the type of offense.

In cases of failure to submit a comprehensive and correct transfer pricing form, or late submission of the form, the date of the violation is the due date for submission of the pertinent form.

If an incomplete or incorrect form is submitted (regardless of whether the submission was on time or late), the date of the offense is the date on which the form was submitted.

**Date of applicability of penalty regime**

The circular confirms the dates as of which the various provisions of the penalty regime are applicable. Offenses that did not entail a wilful intent to harm or to commit fraud committed on or after 19 July 2018 fall within the scope of the penalty regime. Offenses that do entail a wilful intent to harm or to commit fraud are penalized from January 8, 2018.

Going forward, the Belgian tax authorities may be expected to closely monitor compliance with transfer pricing obligations, and to impose penalties in cases of noncompliance.

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## Uruguay extends due date for filing CbC report

On March 27, the Uruguayan tax authorities (DGI) published an administrative resolution that extends the deadline to submit the country-by-country (CbC) report corresponding to fiscal year 2017.

**DGI Resolution**

DGI's Resolution No. 860/2019 provides that the due date to submit the CbC report for fiscal year 2017 is extended to April 30, 2019. According to prior Resolution No. 94/2019, the due date had been set at March 31, 2019. (For prior coverage, see Global TP Alert 2019-001.)
**URL:** https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-19-001-11-january-2019.pdf

Uruguayan taxpayers that are the ultimate parent entity of a large MNE group are required to file a CbC report, as are subsidiaries of foreign-parented groups, when the CbC report is filed in jurisdictions that would not exchange CbC reports with the DGI.

The extension takes into account requests by several companies that have encountered some practical difficulties in complying with the first filing of the report. No further extensions are expected.

The deadline to submit the CbC report notification remains unchanged at March 31, 2019 for fiscal years ending between December 31, 2017 and February 28, 2019. For fiscal years ending after that, the general rule will apply: the CbC report notification must be filed before the last day of the group's relevant fiscal year.



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## 2018 US APA Report shows significant continued interest in APAs

The Internal Revenue Service on March 22 released Announcement 2019-03, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2018. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a summary of recent APA developments in the APMA Program and a statistical snapshot of the program's APA activities during 2018.

Transfer pricing enforcement is expected to continue to increase throughout the world as countries continue to adopt the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) final recommendations, including the enactment of country-by-country (CbC) reporting requirements. In addition, many US and foreign multinational groups are reviewing their existing structures and transfer pricing policies in light of the passage of the 2017 Tax Act (Pub. L. No. 115-97), which may result in operational restructurings and transfer pricing policy changes. The act includes several new international tax provisions that have created complex transfer pricing and international tax issues for both US and foreign multinational groups. Consequently, the certainty provided by APAs will play an increasingly important role in transfer pricing risk management.

Statistical highlights of the APA annual report include:

- **Significant increase in incoming APA requests:** The IRS received twice the number of APA applications in 2018 as it did in 2017. The IRS received 203 APA applications (35 unilateral, 161 bilateral, and 7 multilateral) in 2018, whereas in 2017 it received 101 APA applications. In addition, as of December 31, 2018, APMA had received 71 user fee filings that were not yet accompanied by substantially complete APA applications, almost double the number of user fee filings from 2017.

  The large increase in the number of APA applications may be due in part to accelerated filings arising from the increase in user fees to request an APA that was implemented by the APMA program in two phases during the last year, with the first increase effective on July 1, 2018, and the second increase effective on January 1, 2019.

- **Slight decrease in completed APAs:** During the 2018 calendar year, APMA closed 107 APAs (24 unilateral, 81 bilateral, and 2 multilateral), compared to 116 APAs in 2017. The decrease may be due in part to the reduction in staffing levels in the APMA Program at the end of 2018 compared to the end of 2017, as described further below. APA renewals accounted for 62 of the 107 APAs executed (approximately 58 percent), with 15 unilateral renewals, 45 bilateral renewals, and two multilateral renewals. Approximately 20 percent of all executed APAs included rollbacks. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.

- **Treaty partners involved in bilateral APAs:** In 2018 Japan accounted for 34 percent of bilateral APA requests filed, the largest share of any country. India accounted for 21 percent, showing the continued popularity of US-India bilateral APA requests since the IRS began accepting applications for bilateral APAs with India in February 2016.


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Other countries accounting for meaningful percentages of filed pending, or completed APAs with the United States are Canada, Germany, Italy, Korea, Mexico, the Netherlands, Switzerland, and the United Kingdom.

Nearly 60 percent of the total number of bilateral APAs executed in 2018 involved bilateral APAs with either Japan or Canada. This represents a decrease from 2017, when 73 percent of the total number of bilateral APAs executed involved bilateral APAs with either Japan or Canada. Based on the filed APA requests during 2018 and the IRS's pending inventory of APAs, the percentage of completed APAs with Japan and Canada is expected to continue to decrease as a percentage of the total as other countries become more active in the APA process.

- **Months to complete APAs:** In 2018, the median time to complete a unilateral APA and a bilateral APA was 33.5 months and 42.1 months, respectively. In 2017, the median time to complete a unilateral APA and a bilateral APA was 31.0 months and 35.9 months, respectively. Overall, the median time required to complete the 107 APAs executed in 2018 was 40.2 months, nearly six and a half months slower than in 2017, which is not overly surprising given the reduction in staffing levels at APMA in 2018.

  Processing time for unilateral APAs increased slightly from the prior year. Unlike bilateral APAs, which involve treaty partners, unilateral APAs and their processing time are more controlled by APMA. Due to significantly smaller volumes of unilateral APAs compared to bilateral APAs, the median processing time for unilateral APAs tends to exhibit higher levels of variability than for bilateral APAs. Processing time for bilateral APAs increased from the prior year. For each of the last five years, the median processing time for bilateral APAs has ranged from approximately 35 months to 38 months. In 2018, the median processing time rose to 42.1 months, showing an increase in processing time for bilateral APAs compared to the last five years, which as noted above may be explained in part by the reduction in staffing levels.

  Taxpayers renewing APAs benefitted from slightly faster processing times for their APA requests. For renewal unilateral and bilateral APAs, the median processing time was 40.1 months, compared to the median processing time for new unilateral and bilateral APAs of 41.7 months. The median processing time required to complete new APAs decreased slightly from 43.0 months in 2017 to 41.7 months in 2018.

- **APA inventory:** The APMA Program had 458 cases in active inventory at the end of 2018: 58 unilateral APAs, 387 bilateral APAs, and 13 multilateral APAs. This represents an increase of 72 pending APAs compared to the number at the end of 2017, when there were 386 cases in active inventory, largely due to the increase in the number of APA requests filed. Over half of the pending bilateral APA requests involve either Japan or India.

- **Term length of APAs (including rollback years):** Of the APAs executed in 2018, 36 cases had a five-year term including rollback years, while 63 cases had terms of six years or longer. The average term length in 2018 was seven years, the same as in the previous year. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA request took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.

- **Staffing:** In September 2018, APMA restructured its management and realigned its teams. As of December 22, 2018, the APMA Program was comprised of 56 team leaders, 12 economists, six managers, and three assistant directors (each assistant director oversees two managers who lead teams comprised of team leaders and economists). The three groups overseen by assistant directors are organized by country, with each group having responsibility for multiple countries. The total number of personnel at APMA at the end of 2018 was 77, a decrease from 82 at the end of 2017, and 92 at the end of 2016.

- **Cancellations, revocations, and withdrawals:** No APAs were cancelled or revoked during 2018. Twenty-one APA requests (seven unilateral and 14 bilateral) were withdrawn in 2018, which is significantly higher than the eight applications withdrawn in 2017, and more consistent with the 24 applications withdrawn in 2016.


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- **APAs executed by industry:** In 2018, manufacturing and wholesale/retail trade accounted for 45 percent and 33 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (69 percent of such cases).

- **Covered transactions and transfer pricing methods:** Forty-four percent of the transactions covered in APAs executed in 2018 involved the sale of tangible goods, 35 percent involved the provision of services, and 21 percent involved the use of intangible property, which is consistent with the covered transactions in 2017. For potential cost sharing APAs, taxpayers should also consider that the preamble to the final cost sharing regulations under Treas. Reg. §1.482-7 provides that the IRS has the authority to negotiate an APA covering a platform contribution transaction and include a commensurate with income waiver.

  The comparable profits method (CPM) was used to evaluate 86 percent of the transactions involving the transfer of tangible and intangible property in 2018. Of those transactions, 68 percent used the operating margin as the profit level indicator (PLI) and 32 percent used other PLIs, such as the Berry Ratio and the mark-up on total cost.

  For services transactions, the most frequently applied method was also the CPM (86 percent of cases). Of those services transactions applying the CPM, 76 percent used the operating margin or the mark-up on total cost as the PLI. In 2018, the majority of APAs that covered services transactions also included tangible or intangible transactions, which were not tested under a separate PLI.

  Given that the CPM was used to evaluate 86 percent of transactions involving the transfer of tangible and intangible property and services, it is interesting to note that the IRS APMA Program recently released an Excel-based Functional Cost Diagnostic Model to assist in its analysis of whether certain intercompany transactions may be more reliably measured by applying a profit split methodology rather than a one-sided CPM methodology. For prior coverage, see Global TP Alert 2019-007.
  **URL:** https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-19-007-6-march-2019.pdf

- **Adjustment mechanisms:** The majority of the transactions covered in APAs executed in 2018 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party's results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2018 executed APAs include an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.

- **APA boilerplate and APMA Program contact information:** The annual report also includes the latest version of the APMA Program's model APA agreement and a link to the list of primary APMA Program contacts. APMA made significant revisions to the model APA agreement in May 2018,[6] representing the first substantial update to the model APA agreement since 2004. For prior coverage of the updates to the model APA agreement, see Global TP Alert 2018-018.
  **URL:** https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-18-018-13-june-2018.pdf

In light of the BEPS final reports and the adoption of CbC reporting requirements by many jurisdictions and corresponding increased audit activity, the demand for APAs will undoubtedly continue to be strong. To discuss whether an APA may be advisable for your organization, please reach out to one of the contacts listed.

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[6] On September 4, 2018, APMA released a revised version of the model APA agreement that fixed two problems, including allowing comments and edits to be saved under the specific name of the editor and fixing incorrect phrasing under Appendix A, section 4(b), regarding the royalty for the license of intangible property.


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## Saudi Arabia issues final transfer pricing regulations

The Kingdom of Saudi Arabia's General Authority of Zakat and Tax (GAZT) on February 15 issued final transfer pricing regulations and "frequently asked questions." The final regulations are not a material departure from the draft regulations issued in December 2018, but offer additional guidance and certain welcome extensions regarding the submission of the local file and master file.

**What has stayed the same?**

The final regulations still apply to any person that qualifies as a taxpayer in Saudi Arabia, for reporting periods ending on or after December 31, 2018. The deadline for submission of the disclosure form, and the country-by-country (CbC) report notification for ultimate parent entities (UPEs) and surrogate parent entities (SPEs) not based in Saudi Arabia is 120 days after the fiscal year-end. The CbC report for Saudi Arabia-based UPEs must be submitted 12 months after the fiscal year-end. Guidance regarding exemptions, penalties, definitions, the arm's length principle, approved transfer pricing methods and their application remains unchanged.

**What has changed?**

**Extension for submission of local file and master file:** The final regulations now allow taxpayers up to 30 days to submit a master file/local file, upon the tax authorities' request (a welcome extension from the initial seven days provided under the draft regulations). For calendar year 2019, taxpayers are granted an additional 60-day extension to submit the master file and/or local file, upon request, providing taxpayers with a minimum of 210 days after their fiscal year-end to prepare and submit the documentation (assuming the GAZT request the master and/or local file 120 days after the fiscal year-end).

**Disclosure form:** The draft regulations introduced a requirement for taxpayers to file a disclosure form together with their annual income tax return, which would include general information on the taxpayer's controlled transactions.

The final regulations make a key change regarding the disclosure form. This form now must be accompanied by an affidavit from an auditor licensed to operate in Saudi Arabia certifying that the multinational enterprise's (MNE's) transfer pricing policy is consistently applied by and in relation to the taxpayer with regard to its intragroup transactions.

Given the relatively tight deadline for submission of the disclosure form, taxpayers may wish to start collating evidence to support the application of their transfer pricing policy, although the local file will formally document this going


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forward. It is important to note that the licensed auditor issuing the affidavit must certify the consistent application of the transfer pricing policy, but need not comment on the appropriateness or arm's length nature of the policy itself.

**What has been confirmed?**

**Language of documents:** The GAZT encourages taxpayers to maintain and submit all documentation in Arabic, to the extent reasonably possible.

**Use of local data and updates:** The final regulations confirm that local comparable data are preferred. However, article 13(C) of the regulations permits the GAZT to use foreign comparable data in the absence of local comparables. In such cases, the taxpayer must be able to demonstrate that the foreign comparable data is consistent with the comparability factors set out in article 5 of the regulations.

The final regulations also confirm (in line with OECD guidance) that comparable data should be updated every three years or earlier only if warranted by material changes to the taxpayer's business circumstances. More broadly, the GAZT encourages transfer pricing documentation or specific sections within the documentation to be updated only in the event of material changes to the taxpayer's business circumstances.

**Treatment of pure zakat-paying entities:** The final regulations confirm that pure zakat-paying entities generally are exempt from preparing a master file and/or local file. However, the requirements to file a CbC notification (for non-Saudi UPEs) or prepare and file a CbC report (for Saudi-based UPEs) still apply. MNEs that have excluded pure zakat-paying constituent entities from their prior-year CbC reports should amend their reporting strategy going forward.

**Domestic transactions:** The final regulations confirm that unless expressly exempt (e.g., pure zakat-paying entities), all related-party transactions are within the scope of the regulations, regardless of the place of residence, nationality, or domicile of the counterparty and must be declared on the disclosure form. The purpose of this requirement is to achieve visibility on domestic transactions between zakat- and non-zakat-paying taxpayers, that potentially may create an "income advantage" in Saudi Arabia.

**Comments**

The final regulations provide taxpayers with certainty on their transfer pricing compliance obligations in Saudi Arabia. The extended deadline for first-year master file and local file compliance is welcome, and should allow taxpayers more time to respond in an informed manner. However, the requirement to provide an affidavit with the disclosure form introduces an additional burden on taxpayers to demonstrate a consistent application of their transfer pricing policy.

We encourage taxpayers with a 31 December 2018 fiscal year-end to work back from the 30 April 2019 deadline, to ensure all information required for the disclosure form is gathered and validated.

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## India's ITAT accepts industry average rate as CUP for royalty payments

The Chennai Bench of India's Income Tax Appellate Tribunal (ITAT) ruled on February 4 that since a royalty paid by an Indian subsidiary to its Korean parent company was lower than the industry average royalty rate, the payments were at arm's length and no transfer pricing adjustment was required.
**URL:** https://www.itat.gov.in/files/uploads/categoryImage/1549865263-IT_TP_A%2014-2018.pdf



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**Facts of the case**

The taxpayer, a wholly owned subsidiary of a Korean company, is engaged in the manufacture and sale of passenger cars in and outside India. It pays the Korean parent a royalty of 5 percent on domestic sales and 8 percent on exports for the use of technology and the trade name. The 5 percent and 8 percent rates are specified in regulations issued by the Reserve Bank of India that also specify what constitutes sales for purposes of the royalty calculation.

In the taxpayer's transfer pricing documentation, the royalty transaction was aggregated with all other international transactions and benchmarked using the transactional net margin method (TNMM). During the assessment proceedings for the assessment year (AY) 2006-07, the Indian transfer pricing officer (TPO) determined that the royalty payment made by the taxpayer was excessive and made an ad hoc disallowance of 10 percent of the royalty.

The taxpayer filed an objection before the Dispute Resolution Panel (DRP). After considering the taxpayer's arguments, the DRP called for a remand report requesting the TPO to reanalyze the case, with a specific direction to adopt the comparable uncontrolled price (CUP) method to benchmark the royalty transaction.

The TPO initiated a royalty benchmarking study but was unable to find any appropriate comparables. The TPO issued a notice requesting that the taxpayer conduct the study. In response to the notice, the taxpayer conducted a benchmarking study using a global commercial database of royalty rates and license agreements. The search yielded comparable agreements only for the manufacture of auto components and the taxpayer submitted 10 comparable agreements with an average royalty rate of 7.08 percent.

The TPO in the remand report selectively adopted the taxpayer's report and considered only three comparable companies with an average royalty of 5 percent. On this basis, the TPO concluded that the 8 percent royalties paid on exports were not at arm's length. The TPO also allocated a portion of a lump sum technical know-how payment paid in previous years to AY 2006-07 and included this amount as part of the transfer pricing adjustment.

The taxpayer filed a response to the remand report issued by the TPO, but the DRP did not consider the submission and confirmed the adjustment proposed by the TPO. The taxpayer appealed to the ITAT.

**Issue before the ITAT**

The ITAT was asked to consider:

- Whether based on the facts and in law the DRP was justified in rejecting the TNMM and adopting the CUP method to separately benchmark royalty transactions. The taxpayer requested a without prejudice finding that the CUP method was incorrectly applied by the TPO by selecting as comparables agreements that did not relate to transactions for the manufacture and sale of passenger cars;
- Even assuming the CUP was the most appropriate method, the DRP should have considered the industry average royalty rate of 4.7 percent as the arm's length price;
- The issue already had been addressed in an earlier case involving the taxpayer relating to AY 2007-08, when the average royalty payment in the automotive sector from a study of 35 publicly available licenses of 4.7 percent was compared with the average royalty paid by the taxpayer. The royalty payments were deemed to be at arm's length and the adjustment on account of royalty was removed. Since the royalty agreements entered into by the taxpayer and its associated enterprises were valid for a period of 10 years, the royalty payments for AY 2006-07 were determined on the same basis as those for AY 2007-08 and, therefore, should be accepted as arm's length; and
- The TPO exceeded its jurisdiction by seeking adjustments in respect of the lump sum technical know-how payment, which was not a transaction in AY 2006-07.

**Decision of the ITAT**

The ITAT relied on the ruling in the taxpayer's case relating to AY 2007-08 when the following observations were made:

- The taxpayer had aggregated all the international transactions and benchmarked using TNMM, which demonstrated that the taxpayer's operating margins were higher than those of the comparable companies;


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- The comparable companies selected by the TPO for benchmarking the royalty payment had controlled transactions and, therefore, the benchmarking analysis undertaken by the TPO was unreliable and could not be accepted; and
- The TPO in another context and in respect of a different adjustment had observed that the average royalty payment in the automobile sector was 4.7 percent. This exceeded the taxpayer's average royalty rate of 4.22 percent of net sales per the financial statements, so the royalty transaction was considered to be at arm's length.

Applying the principles established in the ruling in the taxpayer's case for AY 2007-08, the ITAT held that an average royalty payment of up to 4.7 percent on the sales was justified. Since the average royalty rate paid by the taxpayer in AY 2006-07 was 3.64 percent of net sales per the financial statements, the addition in respect of excess royalty should be removed from the assessment.

**Comment**

This is a significant ruling on the payment of royalties, and the ITAT adopted a distinctive approach to determining the arm's length price of the transaction.

The majority of previous judicial decisions in this area focused on one of the following principles:

- Accepting the aggregation approach under the TNMM when the operating margins of the taxpayer after making the royalty payment are higher than the comparables;
- Adopting royalty rates specified by the Reserve Bank of India (5 percent and 8 percent) as the arm's length price; or
- Considering the Foreign Exchange Management Act 1999 guidelines for making royalty payments.

In the case at hand, the ITAT applied a different approach and accepted the average royalty rate prevailing in the automotive sector based on a study of 35 licenses conducted by an independent body as the arm's length price for the purpose of benchmarking the royalty transaction. The Indian tax authorities traditionally have been reluctant to accept royalty benchmarking data from foreign databases. The tribunal's decision to adopt publicly available industry average rates as the CUP for benchmarking royalty payments is welcome and may function as a precedent for other automobile companies facing similar issues.

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