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OECD proposes “unified approach” to Pillar 1 of project to address tax challenges from digitalization of the economy

The OECD on October 9 released a public consultation document on the Secretariat proposal for a “unified approach” under Pillar 1 of the Inclusive Framework’s project to address international taxation in the digitalized economy. Pillar 1 focuses on revising the allocation of taxing rights among countries, potentially including new approaches to nexus (permanent establishment) issues and the arm’s length principle.


Stakeholders are invited to provide comments on the document by Nov. 12. A public consultation will take place in Paris on Nov. 21-22.

The document attempts to narrow the field of options, drawing largely on aspects of the modified residual profit split (MRPS) method and the distribution-based approaches laid out in the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy issued in May 2019, and less so on the fractional apportionment method. The document lays out a three-tier profit allocation mechanism as the foundation of Pillar 1.

The document also suggests that the new approach may go beyond highly digital business models by focusing on “large consumer-facing businesses,” while proposing to exempt certain extractive industries and commodities-related enterprises, as well as perhaps financial services. The proposal indicates a desire to have a threshold over which the new provisions would apply, suggesting EUR 750 million in revenue as an option (similar to that adopted for the country-by-country reporting requirements). This and other provisions will be subject to further discussion and negotiation. It is also possible that there will be a per country dollar threshold that would vary depending on the size of the relevant market jurisdiction.

The document emphasizes that “consumer-facing businesses” will not necessarily be limited to “business to consumer” (B2C) business models only. Rather, factors such as customer engagement and interaction, data collection and exploitation, and marketing and branding will be considered in determining whether the new approach may be appropriate. For example, highly digitalized businesses that interact remotely with users, who may or may not be their primary customers, would likely be in scope. Significant technical work will be needed to distinguish precisely between consumer-facing businesses and other businesses.

The proposal also envisions a new nexus (permanent establishment) rule that is dependent not on physical presence in the user/market jurisdiction but on sales – a commonality among the various tax solutions discussed this year.

The work will be guided by the goal of expanding the reach of taxing authority in market jurisdictions in a way that is simple, avoids double taxation, and significantly improves tax certainty relative to the current practice. The document also notes that the goal of the new rules is that they should apply to situations involving not only positive taxable income but also to those involving tax losses. In addition, consideration will be given to prevent the new rules from creating distortions.

Approach to profit allocation

According to the document, the proposed three-tier mechanism would:

1. Use a formulaic approach to allocate to market jurisdictions a share of a multinational business’ non-routine return attributable to market intangibles (vs. that attributable to other factors, such as trade intangibles), irrespective of the business’ residence or locations (Amount A). This approach allows jurisdictions to maintain taxing rights over income generated through routine activities in that jurisdiction. It is contemplated that the determination of both:
   a. The routine return, and
   b. The portion of the excess (non-routine) return attributable to marketing would be determined by agreed formulas.

2. Provide a fixed return for baseline marketing and distribution functions taking place in a market jurisdiction (Amount B). This return is based on the arm’s length principle, but fixed amounts of return will be explored to minimize disputes.
3. Tax an additional return (Amount C) in accordance with existing transfer pricing rules when a market jurisdiction can successfully establish – subject to robust and binding dispute resolution mechanisms – that there are more functions in the market jurisdictions than have been accounted for and included in Amount B.

The proposed starting point for calculating Amount A is determining a group’s profits, which could be derived from the group’s consolidated financial statement. The document suggests that profits may need to be determined on a business line and/or regional/market basis to avoid distortions that may arise from groups with both high- and low-margin businesses.

The second step would be to determine the group’s “routine” profit; the proposal suggests that a simplified approach would be to use a fixed percentage of sales, potentially with variation by industry. The routine return is then subtracted from the overall profit to produce the non-routine return of the multinational enterprise (MNE) (or the relevant business line). This non-routine return must be further split between the portion of the non-routine return attributable to the market intangibles (as opposed to arising due to trade intangibles and other factors such as risk and capital). The proposal explains that this amount, too, could be determined through the use of a simplifying convention, such as non-routine profit multiplied by an internationally agreed fixed percentage. Finally, once the amount that is attributed to marketing intangibles on a group basis is determined, this amount would be allocated among the jurisdictions based on an agreed allocation key, using variables such as sales.

Practicalities

In several places, the proposed unified approach emphasizes the desire for simplification as changes are contemplated, and it notes that “an administrable solution is essential, especially for emerging and developing countries.” Those countries will broadly need to sign on to any solution that emerges from the Inclusive Framework if there is to be an implementable international consensus.

The devil, of course, will be in the details, and many such details would need to be worked through if stakeholders were to agree to this general architecture – from how a deemed routine return is determined and what percentage of the residual should be reallocated, to the treatment of losses and how to avoid double counting.

The document acknowledges the implementation challenges that lie ahead, including the need for a new nexus rule as a “self-standing treaty provision,” the development of a common withholding tax mechanism for those countries that chose to use one for collection of Amount A, and ensuring simultaneous implementation by all jurisdictions.

Next steps

Separately, the document mentions that a consultation paper on Pillar 2 will be released in November, to be followed by a public consultation in December. Pillar 2 is concerned with the potential creation of a global anti-base erosion proposal, or “GloBe,” to ensure all multinational businesses pay some minimum level of tax. The outline consists of an income inclusion rule, modeled on the US GILTI regime, although with some countries proposing that the minimum tax apply on a country-by-country basis. Policymakers are also considering a tax on base-eroding payments that would be coordinated with the income inclusion rule.

The OECD said during a webcast on October 10 that they hope for greater consensus in 2020, looking in particular to the June 2020 meeting planned for Inclusive Framework participants. When – and if – a general consensus is reached, significant technical work would then follow, and that is expected to take 18 months or more before changes would be ready for implementation.

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Australian Federal Court agrees with taxpayer in court challenge to transfer pricing adjustments

The Federal Court of Australia on 3 September ruled in favor of Glencore Investments Pty Ltd (GIPL) in respect of an appeal from an objection decision under Part IVC of the Tax Administration Act 1953 (TAA). The Australian Taxation Office (ATO) has appealed the court’s ruling.

The elementary transfer pricing lesson that emerges from this case is that, unless the terms of arrangements are such that either the substance does not match the form, or contracting parties acting independently would not have entered into them, the arrangements should be respected by tax authorities and no reconstruction should be attempted.

The other notable outcome of this case is that an appropriate application of the comparable uncontrolled price (CUP) method, when available, continues to serve as a strong and persuasive indicator of how independent parties would contract at arm’s length.

The Commissioner of Taxation issued amended assessments for income years 2007, 2008, and 2009 by exercising his powers under Division 13 of the Income Tax Assessment Act 1936 (ITAA 36) and Subdivision 815-A of the Income Tax Assessment Act 1997 (ITAA 97). The commissioner found that Cobar Management Pty Ltd (CMPL), a wholly owned subsidiary of Glencore International AG (GIAG) and member of a tax consolidated group for which GIPL is the head company, should have received greater consideration because the sale of copper concentrate to its parent GIAG was not arm’s length.

The total additional assessable income over the relevant income years as a result of the amended assessments was AUD 241,060,922. The total shortfall tax payable (exclusive of shortfall interest charge) by GIPL was AUD 82,227,429.

In 1999, CMPL and GIAG entered into an “offtake Agreement” that was structured with certain terms reflecting market-related pricing. In February 2007 the terms of the offtake agreement were amended to change the agreement into what is known in the copper industry as a “price sharing” agreement. This amended agreement was in force during the income years in dispute and was the subject of the commissioner’s focus.

Under this agreement, GIAG bought 100 percent of the copper concentrate produced by CMPL. In consideration for the copper concentrate, GIAG paid CMPL an amount denominated in US dollars pegged to the London Metal Exchange (LME) cash settlement price for copper for the relevant quotational period (QP), with GIAG able to select one of three QPs linked to either the month of shipment or month of discharge of the concentrate – this being referred to throughout the case as the “optionality clause.” The LME cash settlement price paid by GIAG to CMPL was reduced by 23 percent under the price sharing provision, designed to represent a fixed amount for downstream treatment and refining charges (TCRC), which are necessary to convert the concentrate into final copper products. Further reductions from the LME cash settlement price were also built into the contract for relevant freight and insurance costs.

Substituting Arm’s Length Conditions

The commissioner’s Subdivision 815-A and Division 13 case rested on the contention that the offtake agreement, in particular the price sharing provision and optionality clause, were not conditions that arm’s length parties, acting at arm’s length, would have agreed to. The transfer pricing provisions, generally, require that arm’s length consideration (in the case of Division 13) or arm’s length profits (in the case of Subdivision 815-A) be substituted when a taxpayer has transacted with an international party on a non-arm’s-length basis.

In contrast, the taxpayer’s primary case was that, unlike in the recent landmark Chevron decision, when the terms of a loan arrangement between related parties diverged from terms that might be expected between independent parties dealing at arm’s length with each other, the terms governing pricing under the contractual arrangements that applied to the 2007, 2008, and 2009 years were terms that existed in contracts for the sale of copper concentrate between independent market participants and were thus terms that might reasonably and rationally be expected to be found in an agreement between the relevant hypothetical arm’s length parties.
Critical to determining the dispute was resolving which of the competing approaches – the commissioner’s or the taxpayer’s – should be used to identify the relevant arm’s length conditions. The competing approaches can be summarized as follows:

- The commissioner’s argument was that the February 2007 agreement was a non-arm’s-length dealing that favored GIAG to the detriment of CMPL, and that an independent mine producer with CMPL’s characteristics would not have agreed to price sharing at all, or to quotational periods with the optionality clause and, instead, might reasonably have been expected to have sold its production in the relevant years under a life of mine agreement on market-related terms and limited quotational period optionality with no back pricing. If such conditions had obtained, then the commissioner’s view was that a higher consideration would have been paid for the concentrate offtake, and the amended assessments were based on that view.
- The taxpayer’s position was that it was not for the commissioner to disregard the actual contract and transactions and to seek to reconstruct them to his own hypothesis, and that the pricing should be determined based on the actual contractual arrangements in the 2007, 2008, and 2009 years. There was market-based evidence of comparable arrangements, and in particular the fixed discount for the TCRC costs meant that the significant volatility in that aspect of the value chain, which had occurred in the lead-up to the new contract, was assumed by GIAG under the new contract. The optionality clause worked together with the TCRC clause to allow GIAG flexibility in its offtake commitments.

The Federal Court found in favor of the taxpayer, agreeing that the commissioner’s approach “impermissibly restructures the actual contract entered into by the parties into a contract of a different character.” In considering the “restructuring” approach advocated by the commissioner, Davies J referred to the two exceptional circumstances provided for in the 1995 OECD transfer pricing guidelines in which it is appropriate and legitimate to disregard the transaction undertaken by the taxpayer. Both of these exceptional circumstances concern instances where the transaction would not have been determined by normal commercial considerations, but rather, by a taxpayer’s desire to avoid or minimise tax. Justice Davies was not convinced that these exceptions were applicable and, to the contrary, accepted that the form of the offtake agreement was seen in the market, as established by evidence of comparable agreements adduced by the taxpayer to support its case.

Ultimately, Davies J accepted the taxpayer’s submission that the terms of the price sharing provisions were within the arm’s length range as established by the comparable contracts and expert evidence. Further, the evidence was found to provide no basis on which to determine that the QP optionality as provided for in the February 2007 agreement was other than which could be expected between independent parties.

Expert Evidence

As in other transfer pricing cases, both parties relied on expert evidence to support their contentions. Davies J., in her closing comments, sends a strong reminder to future litigants that in transfer pricing cases careful judgment is needed to ensure relevant and properly instructed expert witness evidence is presented to the court in a manner that respects the role of independent expert charged with assisting the Court, and not a particular party in the dispute.

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US Court of Appeals affirms Tax Court decision in Amazon

A unanimous three-judge panel of the Ninth Circuit Court of Appeals on 16 August affirmed the Tax Court’s decision in Amazon.com, Inc. v. Commissioner, 148 T.C. 108 (2017) that the definition of intangible assets under the Treasury regulations in effect in 2005 and 2006 does not include residual business assets such as the value of workforce in...
place, goodwill, and going concern value. The court concluded instead that the definition was limited to independently transferrable assets.

**Background**

At issue were the assets required to be included in a cost sharing buy-in payment in relation to a cost sharing arrangement (CSA) that was entered into as part of a 2004 restructuring by Amazon.com Inc. (Amazon) and its Luxembourg subsidiary. Amazon valued only the independently transferable intangible assets that it transferred to the European holding company under the CSA, including website technology, trademarks, and customer lists. The IRS valued the entire European business, other than preexisting tangible assets. The valuation by the IRS included residual business assets such as workforce in place, goodwill, going concern value, and other unique business attributes such as growth options and Amazon’s culture of innovation.

The Tax Court held in favor of Amazon in an opinion issued 23 March 2017.¹ The Tax Court concluded that the IRS`s buy-in payment included assets that were not included in the definition of intangible property and that therefore were not required to be included in the buy-in payment under the regulations applicable to 2005 and 2006.²

**Ninth Circuit opinion**

The Ninth Circuit upheld the Tax Court’s opinion, holding that the definition of intangible assets in effect during the years at issue did not include residual business assets such as workforce in place, goodwill, going concern value, and other unique business attributes such as growth options. To reach this conclusion, the Ninth Circuit examined the regulatory definition of an intangible contained in the transfer pricing regulations, the overall transfer pricing regulatory framework, and whether the IRS’s position was entitled to deference under *Auer v. Robbins*, 519 US 452 (1997).

**Regulatory definition of an “intangible”:** The Ninth Circuit first analyzed the regulatory text of Treas. Reg. §1.482-4(b) but determined that this alone did not definitively resolve the question.

That language defines an intangible as an asset that both has “substantial value independent of the services of any individual” and is one of the items listed in Treas. Reg. §1.482-4(b)(1) through (6). According to the court, each of the 28 specific items listed in subsections (b)(1) through (5) is independently transferrable, and none is a residual business asset.

The court also examined the catchall provision for “[o]ther similar items” under Treas. Reg. §1.482-4(b)(6), which is the provision the IRS relied on for its analysis. Concluding that such language was ambiguous, the court noted that concepts such as “growth options” and “culture of innovation” are amorphous and that it was not self-evident whether those assets have “substantial value independent of the services of any individual.”

For these reasons, the court held that the regulatory definition of the term “intangible” was not dispositive.

**Overall transfer pricing regulatory framework:** The Ninth Circuit next looked at the transfer pricing regulatory scheme as a whole, viewing the definition of the term “intangible” in the context of the entire set of transfer pricing regulations.

The court noted that the provision requiring a “buy-in” incorporates rather than expands the meaning of an “intangible” given in Treas. Reg. §1.482-4(b). The court then noted that the cost sharing regulations in effect in 2005 and 2006 identified intangibles that were the product of research and development efforts. To the court, this indicated that the regulations contemplated a meaning of “intangible” that excluded items that are generated by earning income, not by incurring deductions, such as goodwill and going concern value.

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¹ For a discussion of the Tax Court opinion, see Global Transfer Pricing Alert 2017-008 (March 27, 2017).
² Also at issue in the Tax Court case was whether a claw-back provision for stock-based compensation in the CSA was operative and whether 100 percent of the costs attributable to certain costs centers were allocable to the CSA cost pool. Neither of those issues was subject to the appeal.
Even though this analysis did not definitively resolve the issue, the court concluded that it favored Amazon’s position more than the IRS’s.

**Rulemaking history of the regulations:** The court then looked at the drafting history of the transfer pricing regulations, concluding that such history did not support the IRS’s argument.

In the court’s view, the only reference in the drafting history to any residual business assets suggests that such items were actually excluded from the definition of intangible assets. The court noted that Notice 88-123, 1988-2 C.B. 458 (the White Paper), which laid the groundwork for what would ultimately become the final regulations at issue in Amazon, proposed including “going concern value” of a research facility in the buy-in payment. Nevertheless, the Treasury Department’s final regulations kept essentially the same definition of the term “intangible” as was used in prior versions of the regulations before the White Paper.

Significantly, the final regulations did not refer to “going concern value” or any other residual business asset.

The court also focused on two statements made by Treasury during the drafting process of the final regulations. First, in 1993, the Treasury Department asked for comments on whether the definition of intangibles should be expanded to include items not normally considered intangible property, such as workforce in place, goodwill, or going concern value. When doing this, the Treasury Department stated that the then-existing definition of “intangible” did not include such residual business assets. Second, a year later, Treasury opted against such an expansion and explained that the final 1994 regulations merely “clarified” when an item would be deemed similar to the 28 items listed in the definition.

The court also focused on another statement from the drafting history of Treas. Reg. §1.482-4 that lent further support for Amazon’s position that the term “intangible” has always been understood to be limited to assets that are independently transferrable. Specifically, the 1993 temporary regulations defined “intangible” as “any commercially transferrable interest” in the intangibles listed in IRC §936(h)(3)(B) that had “substantial value independent of the services of any individual.” The court observed that Treasury, when it left out the “commercially transferrable” language from the final 1994 regulations, explained that such language was superfluous.

Finally, as part of its analysis, the court examined the legislative history of the term “intangible property” under IRC §936(h)(3)(B). The IRS had argued that the 2017 amendment supported its interpretation of Treas. Reg. §1.482-4(b) – that is, that residual business assets such as goodwill, going concern, and workforce in place were intangible assets. Dismissing this argument, the Ninth Circuit, in footnote 16 of the opinion, maintained: “Congress stated that the amendment should not be ‘construed to create any inference’ as to the definition of intangibles for taxable years occurring before the amendment’s effective date. 131 Stat. at 2219. Congress said nothing to indicate that the amendment was meant only as a clarification.”

The court concluded, therefore, that the drafting history of Treas. Reg. §1.482-4(b) strongly supported Amazon’s position that the definition of “intangible” was limited to independently transferrable assets.

**Whether IRS’s position is entitled to Auer deference:** The IRS’s final argument rested on a legal doctrine known as Auer deference, which states that, under certain circumstances, an agency’s interpretation of its own regulations must be given controlling weight as long as it is not plainly erroneous or inconsistent with the regulation. Looking at the text of the regulatory definition of “intangible,” the definition’s place within the transfer pricing regulations generally, and the rulemaking history, the court concluded that Auer deference was not warranted.

**Observations**


The Ninth Circuit’s opinion is limited to issues arising under the 1995 cost sharing regulations. The subsequent cost sharing regulations replaced the reference to buy-in payment with the concept of a platform contribution transaction, which includes any resource, capability, or right that is reasonably anticipated to contribute to developing cost-shared intangibles. In addition, as noted above, the Tax Cuts and Jobs Act amended the definition of intangible property to include workforce in place, goodwill, and going concern value.
In analyzing these changes, the court stated in footnote 1 of the opinion that, "[i]f this case were governed by the 2009 regulations or by the 2017 statutory amendment, there is no doubt the Commissioner’s position would be correct.” This language, along with the language in footnote 16 of the opinion, may impact consideration of this issue in years governed by the 2009 temporary regulations and before the effective date of the TCJA.

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OECD’s newly released 2018 MAP statistics indicate total number of cases continues to increase

The OECD on 16 September issued the 2018 mutual agreement procedure (MAP) statistics, which provide detailed information regarding the MAP activities of 89 OECD and G20 jurisdictions. According to the OECD, these statistics indicate that the aggregate number of MAP cases continues to increase, even though tax administrations are closing an increasing number of cases. In part, this result reflects that the number of new transfer pricing cases is rising faster than the number of transfer pricing cases closed.

Background

Under BEPS Action Item 14 (Making Dispute Resolution Mechanisms More Effective) jurisdictions committed to a minimum standard regarding resolution of treaty-related disputes in a timely, effective, and efficient manner. All 134 members of the Inclusive Framework on BEPS committed to implement the Action 14 minimum standard, which also provides for timely and complete reporting of MAP statistics pursuant to an agreed framework. The 2018 MAP statistics are reported using this new framework.


Total MAP Caseload

The MAP Statistics Reporting Framework distinguishes between cases that were initiated before and after 1 January 2016. The latter date is the date on which the reporting jurisdictions committed to implement the Action 14 minimum reporting standard. The Reporting Framework also distinguishes transfer pricing cases (which for this purpose include cases that involve the attribution of profits to permanent establishments (PEs)) and “other cases” accepted into MAP. For jurisdictions that joined the Inclusive Framework after 31 December 2016, the distinction with respect to timing is between cases received before and after 1 January of the year in which the country joined the Inclusive Framework.

With that in mind, the total number of MAP cases is as follows:

<table>
<thead>
<tr>
<th>All cases</th>
<th>2018 Starting inventory</th>
<th>Cases initiated in 2018</th>
<th>Cases closed</th>
<th>Ending inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases received prior to 1 January 2016 of the year of joining the BEPS Inclusive Framework</td>
<td>4,586</td>
<td>0</td>
<td>1,231</td>
<td>3,355</td>
</tr>
<tr>
<td>Cases received on or after 1 January 2016 of the year of joining the BEPS Inclusive Framework</td>
<td>2,338</td>
<td>2,385</td>
<td>1,473</td>
<td>3,250</td>
</tr>
</tbody>
</table>

The number of transfer pricing cases closed in 2018, and the ending inventory of these cases is as follows:
Transfer pricing cases*

<table>
<thead>
<tr>
<th>Cases received prior to 1 January 2016 or of the year of joining the BEPS Inclusive Framework</th>
<th>Starting inventory</th>
<th>Cases initiated in 2018</th>
<th>Cases closed</th>
<th>Ending inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,599</td>
<td>0</td>
<td>7,54</td>
<td>1,845</td>
<td></td>
</tr>
<tr>
<td>Cases received on or after 1 January 2016 or of the year of joining the BEPS Inclusive Framework</td>
<td>1,132</td>
<td>930</td>
<td>394</td>
<td>1,668</td>
</tr>
</tbody>
</table>

Of the total number of cases in MAP inventory – 6,605 – transfer pricing cases account for 3,513, or 53 percent of the total. Of the total 3,513 transfer pricing cases in inventory at the end of 2018, the largest number of cases involve India with 710, followed by the United States with 670, France with 560, and Italy with 501.

The individual country data show a decrease in inventory in about half the reporting jurisdictions and an increase in the other half. Compared to 2017, new transfer pricing cases in 2018 have increased by almost 20 percent, and other cases increased by more than 10 percent. As a result, despite a greater number of cases closed, the aggregate number of cases in the global inventory increased.

The table below lists the countries that received the largest number of new transfer pricing cases in 2018:

<table>
<thead>
<tr>
<th>All cases</th>
<th>2018 Starting inventory</th>
<th>Cases initiated in 2018</th>
<th>Cases closed</th>
<th>Ending inventory</th>
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<td>2,385</td>
<td>1,473</td>
<td>3,250</td>
</tr>
</tbody>
</table>

Average time to close MAP cases

Under the Action 14 minimum standard, jurisdictions undertook to resolve MAP cases within an average time frame of 24 months. According to the OECD statistics, the average time needed to close a MAP transfer pricing case in 2018 was 33 months, up from 30 months in 2017. By comparison, for other cases, the average time to closure was only 14 months, down from 17 months in 2017. This disparity in time to completion may not be surprising, given that many transfer pricing disputes referred to MAP tend to raise more complex, fact-intensive issues.

Average times for case resolution varied significantly by jurisdiction, ranging from 2 to 66 months. Roughly 60 percent of the reporting jurisdictions met the 24-month goal across all cases, which was similar to the results in 2017.

MAP outcomes

Of the transfer pricing cases closed in 2018, an agreement fully or partially resolving taxation not in accordance with a tax treaty was reached in almost 75 percent of the cases. Unilateral relief was granted in 5 percent of all cases, and 5 percent of the cases were resolved through a domestic remedy. Only 2 percent of all MAP cases were closed because the competent authorities could not reach a mutual agreement.
US statistics

In addition to the global MAP statistics described above, the OECD released data for each of the 89 participating jurisdictions. The United States started the year with 694 cases in inventory and closed 181 transfer pricing cases in 2018. However, 157 new cases were initiated, for a closing total of 670 cases.

<table>
<thead>
<tr>
<th>Cases started before 1 January 2016</th>
<th>2018 Starting inventory</th>
<th>Cases initiated</th>
<th>Cases closed</th>
<th>2018 Ending Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer pricing cases</td>
<td>429</td>
<td>0</td>
<td>90</td>
<td>339</td>
</tr>
<tr>
<td>Other cases</td>
<td>189</td>
<td>0</td>
<td>29</td>
<td>160</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cases started after 1 January 2016</th>
<th>2018 Starting inventory</th>
<th>Cases initiated</th>
<th>Cases closed</th>
<th>2018 Ending Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer pricing cases</td>
<td>265</td>
<td>157</td>
<td>91</td>
<td>331</td>
</tr>
<tr>
<td>Other cases</td>
<td>122</td>
<td>96</td>
<td>41</td>
<td>177</td>
</tr>
</tbody>
</table>

Of the 181 cases closed in 2018, 161 were resolved based on an agreement that fully or partially eliminated double taxation or taxation not in accordance with the tax treaty.

The lack of uniform starting dates and the use of different reporting conventions by specific countries may suggest that the historic (pre-2016) data may have reduced reliability, although they remain useful in discerning overall trends. The pre-2016 data for specific countries also permit evaluation of the effectiveness of the procedures in specific jurisdictions. As countries fully adopt the reporting standard under BEPS Action Item 14, the aggregate data for post-2016 cases will become more useful as an indicator of aggregate trends and will indicate the extent to which countries are achieving the standards for timely and effective resolution of MAP cases under BEPS Action Item 14.

Timely filing MAP requests

Practitioners should keep in mind that competent authority assistance to relieve double taxation is available under the MAP articles of most or all income tax treaties. To grant relief from double taxation, the relevant competent authorities must either be notified of the proposed transfer pricing adjustments, or a formal request for MAP assistance must be filed with them, within the specific time limits in the applicable income tax treaty. Failure to make the appropriate filings can result in denial of the taxpayer’s request for competent authority relief to eliminate double taxation. For a more detailed discussion of the deadlines to preserve taxpayer rights to request competent authority assistance to relieve double taxation, see Global Transfer Pricing Alert 18-030.


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Denmark will allow reopening of old tax years following transfer pricing ruling

The Danish Tax Agency has published new guidance that allows the reopening of old tax years – back to 2008 – if certain conditions are met. The guidance comes in response to the Supreme Court’s January 2019 ruling in favor of Microsoft. (For prior coverage, see Global TP Alert 2019-014).
**Court decision**

The ruling on the Microsoft case – SKM2019.136.HR – addressed the question whether the Danish tax authorities were allowed to perform a discretionary assessment in relation to an intercompany compensation charge for marketing activities performed by a Danish company on behalf of its Irish counterparty. The tax authorities claimed that the transfer pricing documentation was not prepared within the deadline stipulated in Danish transfer pricing requirements.

The Supreme Court rejected the tax authorities’ position and concluded that the tax authorities did not have a legal basis to deem the prepared transfer pricing documentation so insufficient that it could be considered non-existent documentation. The Court upheld a lower tribunal’s decision to reject the Danish tax authority’s proposed adjustment of commission payments for marketing activities.

**New Guidance**

Under the new guidance, taxpayers that were subject to a discretionary transfer pricing adjustment by the Danish Tax Agency, based solely on the fact that transfer pricing documentation, in its entirety, was not prepared at the due date for filing the Danish income tax return, can have the affected tax years reopened. As a condition for reopening the affected tax years, taxpayers must be able to document that the Tax Agency’s assessment was not made in accordance with the Danish Tax Assessment Act section 2 (the Danish arm’s length principle).

The oldest tax year that can be reopened as a result of the new guidance is 2008.

Whether a specific tax year can be reopened as a result of the new guidance will depend on an analysis of the facts and circumstances of each individual case.

Unless the ordinary statute of limitation rules applies, the deadline to submit a request for reopening is 12 January 2020, six months from the date of the new guidance.

The Danish Tax Control Act was changed effective 1 January 2019; thus, the guidance published by the Danish Tax Agency affects only tax years starting before that date. The new Tax Control Act provides that transfer pricing documentation must be prepared on an ongoing basis and must be finalized no later than the date of filing the Danish income tax return.

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**Ireland’s Department of Finance issues draft transfer pricing legislation**

The Irish Department of Finance on 2 September issued “Ireland’s Transfer Pricing Rules Feedback Statement,” which contains draft legislation to update Ireland’s domestic transfer pricing regime from 1 January 2020.


The document follows a period of public consultation launched in February 2019 to collate views regarding updating Ireland’s domestic transfer pricing law to align with the 2017 OECD transfer pricing guidelines and other amendments.
to broaden the scope of transfer pricing law in Ireland. (For prior coverage of the public consultation, see Global TP Alert 2019-005).


The draft legislation contained in the feedback statement represents a fundamental rewriting of the existing domestic transfer pricing law. The contents of the feedback statement are expected to be included in the forthcoming Finance Bill in October 2019. The proposed changes, if implemented as set out in the draft legislation, would be effective from 1 January 2020.

Feedback statement details

The 24-page feedback statement contains draft legislation amending Part 35A of the Taxes Consolidation Act 1997 (TCA 1997) which, in the words of the Department of Finance, “could apply for chargeable periods commencing on or after 1 January 2020.” The relevant draft provisions are discussed in more detail below.

Basic transfer pricing rules

The current legislation as contained in Section 835C TCA 1997 is updated to broaden the applicability of the transfer pricing rules to not only trading income and expenses for companies in Ireland but also to non-trading income and expenses taxed at 25 percent. Also within the scope of the proposed new legislation are arrangements relating to the acquisition and disposal of chargeable assets (such as tangible and intangible assets).

Also included in the proposed Section 835C TCA 1997 are new provisions that allow the recharacterization of transactions for transfer pricing purposes. The current transfer pricing law in Ireland can be interpreted to preclude recharacterization, but the new provisions make it clear that when the form of a financial or commercial arrangement is inconsistent with the substance of the relations between related parties transacting with each other, the arm’s length conditions may be determined by the actual commercial or financial arrangements in place between the parties.

Interestingly, the legislators decided to include specific clauses in this section to deal with recharacterization, bearing in mind that the 2017 OECD transfer pricing guidelines already contain updated guidance in this area in Chapter I, D2 – “Recognition of the accurately delineated transaction.” Taxpayers will need to consider both the OECD and Irish domestic provisions in this area when determining the characterization of intercompany transactions for transfer pricing purposes.

Incorporation of OECD guidance into Irish legislation

The current wording included in Section 835D TCA 1997 refers to the 2010 version of the OECD transfer pricing guidelines. The proposed amendments to this section explicitly refer to the relevant guidelines published by the OECD, which will be applicable from 1 January 2020, including:

- The 2017 OECD transfer pricing guidelines issued on 10 July 2017;
- The Guidance for Tax Administrations on the Application of the Approach to Hard-To-Value-Intangibles issued on 4 June 2018;
- The Revised Guidance on the Application of the Transactional Profit Split Method issued on 4 June 2018; and
- Any additional guidance the OECD may publish subsequent to the updating of the current domestic legislation that may be brought forward by Ministerial Order.

Grandfathered arrangements

The existing Irish transfer pricing rules allow for the exemption from the transfer pricing rules of certain arrangements entered into before 1 July 2010, to the extent the terms and conditions of such arrangements did not subsequently change. The proposed new legislation would remove this exemption for chargeable periods beginning on or after 1 January 2020. It should be noted that Section 835F TCA 1997, which contains documentation provisions, still exempts “grandfathered” transactions from documentation requirements when both parties to the transaction are Irish tax resident companies. Such transactions between Irish tax resident companies will still need to be priced at arm’s length, irrespective of the fact that there will be no formal documentation requirements in place.
When an Irish tax resident company has a “grandfathered” transaction with a foreign related party, no exemption would be available, that is, transfer pricing documentation requirements would be applicable under Section 835F.

**Extension of transfer pricing rules to SMEs**

Small and medium-sized enterprises (SMEs) are currently outside the scope of Irish transfer pricing documentation requirements. The exemption is based on EU Recommendation 2003/361/EC, as issued by the European Commission on 6 May 2013. The proposed amendments to Section 835E TCA 1997 contained in the draft legislation refine the operation of the SME exemption under Irish law for transfer pricing purposes.

Companies classified as “small enterprises” would continue to fall outside the ambit of Ireland’s domestic transfer pricing documentation requirements from 1 January 2020, but would still be required to adhere to the arm’s length principle. However, companies classified as “medium enterprises” would be subject to the domestic transfer pricing law provisions (including documentation requirements) from 1 January 2020.

The applicable EU-based thresholds rely on monetary thresholds and staff numbers on a consolidated global group basis, as listed in EU Recommendation 2003/361/EU:

<table>
<thead>
<tr>
<th></th>
<th>Staff headcount</th>
<th>(Annual turnover) AND</th>
<th>Balance sheet total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>&lt; 50</td>
<td>≤ €10 million OR ≤ €50 million</td>
<td>≤ €10 million</td>
</tr>
<tr>
<td>Medium</td>
<td>&lt; 250</td>
<td></td>
<td>≤ €43 million</td>
</tr>
</tbody>
</table>

The proposed changes dealing with medium-sized enterprises also provide that transfer pricing documentation requirements would be applicable only to certain “relevant arrangements.” These are:

- Arrangements that are within the charge to tax under Schedule D for the Irish company as either an expense or income item, the arrangement in place is with a “non-qualifying relevant person” (e.g., a foreign counterparty), and the aggregate consideration payable or receivable in the accounting period exceeds EUR 1 million;
- Arrangements that involve the supply or acquisition of an asset (tangible and intangible) that constitutes a disposal or acquisition under Ireland’s capital gains tax provisions, where the counterparty to the transaction is not tax resident in Ireland and:
  - The asset immediately after it is acquired by the other person is not a chargeable asset (that is, it’s not within the charge to tax in Ireland); or
  - The asset immediately before it is acquired by the Irish company is not a chargeable asset for the other person (that is, it’s not within the charge to tax in Ireland); and
  - The market value of the asset disposed of or acquired exceeds EUR 25 million.

The proposed legislative amendments also exclude transfers of assets between Irish tax resident companies from the scope of the transfer pricing documentation requirements. Such transfers may also be subject to group relief under the relevant Irish capital gains tax provisions to provide exemption from a tax charge.

Finally, the proposed amendments provide that medium-sized enterprises would be subject to reduced transfer pricing documentation requirements and would be required to provide the following details to satisfy documentation requirements:

- A description of the business of the medium-sized enterprise, including organizational structure, business strategy, and key competitors; and
- For each relevant arrangement:
  - A copy of all relevant agreements;
  - A description of the transfer pricing method used and the reasons for selection, together with supporting evidence that the price selected represents the arm's length price;
  - The amount of the consideration payable or receivable; and
  - A description of the functions performed, risks assumed, and assets employed.
Enhanced transfer pricing documentation requirements

The proposal would update Section 835F TCA 1997 to provide specific requirements for companies within scope to prepare transfer pricing documentation in accordance with Annex I and II of the 2017 OECD transfer pricing guidelines, that is, the master file and local file approach.

The draft legislation provides for consolidated revenue-based thresholds to apply before it is necessary to prepare the master file and/or local file as follows:

- **Master file**: Revenue threshold of EUR 250 million
- **Local file**: Revenue threshold of EUR 50 million

The due date for completion of the relevant documentation would be contemporaneous with the filing of the annual corporation tax return, approximately nine months after the end of the accounting period. The relevant documentation must be made available upon request in writing by Irish Revenue within 30 days of the request. There is no requirement to file transfer pricing documentation with the corporation tax return.

The section also includes provisions dealing with arrangements that were in place before 1 July 2010 (grandfathered arrangements). Draft Section 835F(4) sets out that documentation would not be required to be provided to the Irish Revenue for such arrangements when both parties to the arrangement are Irish tax resident companies. However, as discussed above, the feedback statement indicates that exemption from transfer pricing for grandfathered arrangements would cease from 1 January 2020. This means that while there would be no requirement to have transfer pricing documentation for domestic grandfathered arrangements, such arrangements would still need to be priced at arm’s length.

Special transfer pricing rules for non-trading income

The proposal inserts a new Section 835CA TCA 1997 into Part 35A that is to be considered in conjunction with Section 835C TCA 1997 (Basic Rules on transfer pricing). Subsection 3 of Section 835CA indicates that transactions between two Irish tax resident companies that are not taxed under Case I or II of Schedule D for either company are exempt from transfer pricing requirements. This means that in the case of two Irish tax resident companies that transact with each other and the underlying arrangement is a non-trading transaction that is taxed under Case III to V rules (interest income, rental income) for both companies, there would be no requirement to apply transfer pricing principles. However, if the arrangement involves an Irish tax resident company that is taxed under Case III to V rules and the counterparty entity is a foreign company outside the Irish tax net, this exemption would not apply. Thus, the basic transfer pricing rules contained in Section 835C TCA 1997 would continue to apply to the Irish company.

In addition, the above principles would not apply (and therefore the transfer pricing rules would be applicable) when:

- One of the Irish tax resident companies is subject to tax under Case I or II of Schedule D; or
- The arrangement between the two Irish tax resident companies is part of a scheme involving a second arrangement (presumably with a foreign related party) and the main purpose of the first arrangement between the two Irish tax resident companies is to obtain a tax advantage in connection with the second arrangement.

These complex anti-avoidance provisions contained in the draft legislation appear to be aimed at certain interest-free loan transactions involving Irish tax resident companies with foreign related parties.

Extending transfer pricing rules to capital transactions

With the proposed extension of transfer pricing rules to capital transactions, certain provisions in the existing transfer pricing law that deal with capital allowances and the interaction with the broader tax acts that deal with chargeable gains on dealings involving capital assets must be considered.

Section 835H TCA 1997 deals with the interaction of transfer pricing and capital allowances. The section is rewritten, and the draft legislation confirms that the application of transfer pricing law will not apply in certain circumstances, including:
In the determination of capital allowances on capital expenditure when the total expenditure incurred on the asset does not exceed EUR 25 million;
In the determination of certain balancing charges to be levied under the tax amortization regime for qualifying intangible assets under Section 291A TCA 1997;
In the determination of a balancing allowance or charge when the market value of the asset at the time of the event giving rise to the balancing adjustment does not exceed EUR 25 million; and
Other circumstances apply when the acquirer and supplier of the asset make certain joint elections for capital allowances purposes, certain transfers governed by other sections of the Irish tax acts (such as company reconstructions and amalgamations, mergers, farm buildings and conversions).

A new Section 835I TCA 1997 is inserted that deals with the applicability of transfer pricing rules in computing arm’s length chargeable gains or allowable losses on the transfer of assets between related parties. The section indicates that transfer pricing rules would not apply in computing the chargeable gain or allowable loss when certain circumstances apply, including:

- When the market value of the asset does not exceed EUR 25 million upon disposal or acquisition; and
- When disposal or acquisition occurs and other sections of the tax acts apply (such as those dealing with company reconstructions and amalgamations and certain intragroup transfers).

The EUR 25 million amount referred to in the section would include the value of any other asset that had at any time formed part of the asset being disposed/acquired, and the value of any asset subject to any scheme in place to avoid reaching the EUR 25 million threshold to disapply transfer pricing rules.

Comments

The draft transfer pricing legislation as contained in the feedback statement is likely to materially form part of the finalized legislation that will progress through the Irish Parliament in the autumn of 2019. The issues addressed in the document are open for further consideration and feedback by interested stakeholders until 13 September 2019.

The rewrite of Ireland’s transfer pricing law represents a substantial change to existing laws, not only aligning Ireland’s law with the latest OECD principles but also broadening the regime to non-trading and capital transactions, with associated implications with regard to related parts of Ireland’s tax law that must be considered. Certain changes, including enhanced language dealing with recharacterization and anti-avoidance clauses aimed at certain perceived tax planning structures, provide the Irish Revenue with increased tools to apply transfer pricing principles to some transactions.

A noteworthy item that has been deferred relates to extending transfer pricing rules to branch profit allocations. The public consultation had sought stakeholder feedback on the introduction of the OECD Authorized Approach into domestic law, but it has been decided to defer any changes until further consultation takes place.

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Panama establishes regulatory framework for country-by-country report

Panama’s government on 27 May issued an executive decree that establishes the regulatory framework for submission of the country-by-country (CbC) report.

Background

The Republic of Panama joined the OECD’s Inclusive Framework for the implementation of BEPS actions on 31 October 2016.
Among the minimum standards contemplated in the BEPS actions is the strengthening of the Transfer Pricing Documentation, expanding the requirements for the local Report, known as the transfer pricing study and creating new reports such as the Master Report and the Country-by-Country Report, through Action 13, which the Republic of Panama is committed to implementing.

Panama then issued Executive Decree 390 of 24 October 2016, which establishes the master file requirement. Executive Degree No. 46 of 27 May 2019, establishes the regulatory framework for the CbC report.

**Obligation to submit CbC report**

Every ultimate parent entity of a multinational entity (MNE) group that has consolidated income exceeding EUR 750 million or its equivalent in Panamanian currency (the balboa) (at the exchange rate as of January 2015) and is domiciled in Panama for tax purposes will be required to submit a CbC report annually.

**Notification of the CbC report**

The entity that belongs to an MNE group that is domiciled in Panama for tax purposes must notify the Panamanian tax authorities of the identity and fiscal residence of the reporting entity, as well as the fiscal period used by the MNE group.

**Contents of CbC report**

The MNE group’s CbC report must include the following information:

- Amount of income, profit or loss before taxes, income tax paid, income tax accrued, declared capital, retained earnings, number of employees, and tangible assets other than cash or cash equivalents, regarding each one of the jurisdictions in which the MNE group operates.
- Identity of each entity in the MNE group, and the tax jurisdiction of each entity. When an entity’s jurisdiction of tax residence differs from the jurisdiction in which it was legally constituted, the reporting entity must provide the name of the jurisdiction under which the entity was legally constituted. The report also must include the nature of the main business activity of that entity.
- Any additional information or explanation that is necessary or facilitates the understanding of the information contained in the CbC report.

**Filing format and submission due date**

Reporting entities must submit the CbC report annually in the "XML Schema" format, following the regulations and guidelines provided by the tax authorities. The CbC report must be submitted electronically through an internet portal established for that purpose. The report must be filed within 12 months following the end of the tax year.

The first CbC reports that must be filed are those for the 2018 tax year.

**Inquiries**

The executive decree provides a procedure for the submission of inquiries regarding the CbC report to the tax authorities. Whoever has a personal and direct interest may submit an inquiry, based on an actual situation, to the tax authorities to clarify the meaning and scope of Executive Decree 46 and any other current or future provision that regulates the automatic exchange of CbC reports.

Individuals may formulate their inquiries by themselves; however, legal entities must formulate their inquiries through a legal representative, and, in both cases, the requirements established for that purpose must be met. The authorities must respond to any inquiry that meets the requirements within a two-month period, unless a longer period is required.
Saudi Arabia starts requesting transfer pricing documentation

The Kingdom of Saudi Arabia’s (KSA’s) General Authority of Zakat and Tax (GAZT) has started requesting taxpayers’ transfer pricing documentation.

Background

Under the KSA transfer pricing bylaws, which were introduced in February 2019 and are applicable for tax returns filed on or after 1 January 2019, taxpayers are required to prepare transfer pricing documentation (local file and master file) at the time of filing their tax return. (See Arm’s Length Standard, February 2019.) After submission of the tax return and the required disclosure form summarizing transfer pricing information, the GAZT may request that the taxpayer furnish these within 30 days.

URL: http://newsletters.usdbriefs.com/2019/Tax/ALS/190211_1.html

Requests for documentation

In July 2019, the GAZT started sending notices to taxpayers that they must submit their transfer pricing documentation to the tax authorities. These notices have come in the form of an email from the taxpayer’s relationship manager at GAZT. The requests for documentation have not been made by GAZT on a standalone basis, but are part of a broader information-gathering process to kick-start a broader tax audit.

GAZT also has updated the Taxpayers Services Catalogue on their website. The catalogue describes the process for submission of transfer pricing documentation, which includes uploading the documentation on to the GAZT portal after logging in with the taxpayer’s credentials.


Information requested

The catalogue indicates that in addition to the master file and the local file, the GAZT may request other relevant documents related to transfer pricing.

Based on our experience to date, the GAZT appears to be requesting the multinational entity (MNE) group’s transfer pricing policy document, which must have been certified by a licensed auditor in KSA in an affidavit, and an explanation of its applicability to the KSA taxpayer.

Other items that GAZT has requested include intercompany agreements and comparability analyses demonstrating that the taxpayer’s related-party transactions were conducted on an arm’s length basis (in some cases to support a loss-making subsidiary in KSA).

Deadline to provide information

In accordance with the KSA transfer pricing bylaws, taxpayers are given a minimum of 30 days to provide the documentation requested.

The catalogue clarifies that GAZT will provide 30 business days to taxpayers to submit their transfer pricing documentation. In practice, we have seen GAZT extend the deadline to provide documentation to 30 business days,
compared to the minimum of 30 days the TP bylaws provide. This should provide some relief for taxpayers, as they may get an additional week or two to submit their transfer pricing documentation, depending on the specific circumstances.

It is unclear whether GAZT will grant taxpayers any additional extensions to furnish their documentation.

**Red flags**

The GAZT has now received the transfer pricing disclosure forms submitted by taxpayers as part of their tax return for tax year 2018, and it is likely to have conducted preliminary transfer pricing assessments of the data included in those disclosure forms.

The key "red flags" are likely to be as follows:

- Losses reported in the tax return with high related-party expense transactions;
- Related-party transactions with foreign entities located in zero-tax jurisdictions;
- Selecting "business restructurings" from the drop-down menu in the transfer pricing disclosure form;
- Selecting zero-consideration transactions from the drop-down menu in the disclosure form;
- Poorly prepared disclosure forms, with transactions that do not match those included in the financial statements; and
- Affidavits not submitted as part of the disclosure form.

**Next steps**

It is important that taxpayers in KSA check their emails and be on standby to respond to these requests for transfer pricing documentation.

Comprehensive transfer pricing documentation will go a long way in reducing the risk of a transfer pricing assessment.

Taxpayers that do not currently maintain a transfer pricing policy document and copies of the intercompany agreements that govern their controlled transactions should prepare such documents going forward, in addition to maintaining a master file and a local file.

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Denmark proposed legislation would amend transfer pricing rules

Denmark’s Parliament introduced draft legislation on 13 September that would require taxpayers to submit their transfer pricing documentation with their income tax returns. The draft legislation also clarifies the Danish Tax Agency’s ability to conduct discretionary assessments in accordance with the Danish Tax Control Act.

The proposals are part of the effort to implement the EU’s Council Directive 2016/1164 of 12 July 2016 regarding tax avoidance practices that directly affect the functioning of the internal market.

Transfer pricing documentation to be submitted together with company’s tax return

The draft legislation provides that taxpayers must submit their transfer pricing documentation to the Danish Tax Agency simultaneously with the company’s income tax return. Under the existing rule in paragraph 39 of the Tax Control Act, transfer pricing documentation must be finalized at the time of filing the tax return and submitted to the Danish Tax Agency upon request. Parliament’s new proposal would eliminate the existing rule that gives taxpayers 60 days from the day of a request to submit their transfer pricing documentation to the Danish Tax Agency.

Under the existing rules, transfer pricing documentation must be prepared contemporaneously and must be finalized at the time of filing the income tax return. However, the transfer pricing documentation need not be submitted before the Tax Agency requests it.

The proposal does not change the existing rules on penalties; thus, late submissions, no submissions, or submission of insufficient documentation (documentation the tax authorities cannot use to determine whether prices and terms have been set in accordance with the arm’s length principle) can be penalized (Tax Control Act article 84 (1) no. 5).

If the draft legislation is enacted, the proposed changes would enter into force on 1 January 2020 and would have effect for income years starting on or after 1 January 2020.

Clarification regarding options for conducting discretionary assessments

The draft legislation also proposes amending paragraph 39 (3) of the Danish Tax Control Act to stipulate that the Danish Tax Agency has the right to conduct a discretionary assessment if transfer pricing documentation has not been prepared in a timely manner, that is, if it is not submitted to the Danish Tax Agency along with the company’s income tax return, regardless of whether the taxpayer submits the transfer pricing documentation after the date of submission of its tax return. Thus, if adopted, this proposal would allow the Danish Tax Agency to include only the transfer pricing documentation – if submitted – and the information received together with the tax return, to determine whether there is a basis for a discretionary assessment of the taxable income. As a result, the proposal could effectively lower the requirements for the Danish Tax Agency’s access to perform discretionary assessments.

The existing legislation provides that the Danish Tax Agency may issue a discretionary assessment if the taxpayer’s transfer pricing documentation upon submission is insufficient to determine accordance with the arm’s length principle or if it is missing (article 46(1) of the Tax Control Act).

The proposed changes to the existing legislation may change before the final legislation is in place.

The Danish Tax Control Act’s provisions on preparation of transfer pricing documentation for controlled transactions have most recently been amended with effect from 1 January 2019 as part of the modernization and rewriting of the Danish Tax Control Act.

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Australia issues guidance on nonresident-owned mobile offshore drilling units in Australian waters

On 26 September 2019, the Australia Taxation Office (ATO) released a draft Practical Compliance Guideline (PCG 2019/D5) on its compliance approach for offshore drilling and associated activities. Specifically, the guideline relates to “transfer pricing issues involving the use in Australian waters of nonresident owned mobile offshore drilling units (MODUs).” The draft guideline is proposed to apply both before and after the date of issue.

The draft PCG follows Taxpayer Alert TA 2016/4 (published in April 2016), in which the ATO expressed concerns about whether the amount brought to tax in relation to various cross-border leasing arrangements involving mobile assets is consistent with the contribution made by the Australian operations.

Similar to other PCGs, PCG 2019/D5 provides a risk assessment framework that outlines the ATO’s compliance approach to the transfer pricing issues. The draft guideline deals with the use in Australian waters of nonresident-owned MODUs, with criteria for the classification of taxpayers with certain “risk zones,” along with the consequences of falling within a particular risk zone. Disclosure to the ATO of the self-assessed risk zone may be required in the Reportable Tax Position schedule (or at the ATO’s request).

To whom does the guideline apply?

The draft guideline addresses the transfer pricing issues related to the use of these assets in Australian waters by the “operator” of the asset, whether an Australian tax resident or nonresident entity with a permanent establishment in Australia. Activities associated with offshore drilling could include input to attract and engage customers, secure contracts, project management, engineering, design, procurement, construction technology, health, safety and regulations, maintenance and vessel repairs, crewing services, or office support.

Under the guideline, MODUs include drill-ships, drilling rigs (including but not limited to submersibles, semi-submersible, and jack-up rigs), pipe-laying vessels, and heavy-lift vessels.

This guideline does not apply to:

- Oil and gas production platforms that are not engaged in any drilling activities and are permanently anchored to the ocean floor;
- Cable-laying vessels that lay telecommunications and electric power transmission systems, operating in a different industrial context, under quite different technical and regulatory conditions, risks, and economic circumstances;
- Port works, such as hard-stand construction, dredging, rock-dumping, reclamation, and associated activities, which involve quite different technical and regulatory conditions, risks, and economic circumstances; or
- Tax risks other than tax transfer pricing risk.

The guideline also does not apply if the substance of the arrangements differs from their legal form.

PCG risk zones

The ATO has constructed four risk zones, summarized below. It does not necessarily follow that having a low risk rating under this guideline means that a taxpayer’s transfer pricing outcomes are correct or that they have a reasonably arguable position. Similarly, having a high-risk rating under this guideline does not necessarily mean that a taxpayer’s offshore drilling and associated activities fail to comply with Australia’s transfer pricing rules.
White zone

Entities will be deemed to be within the white zone if they have an advance pricing agreement (APA) in respect of their arrangement, an agreed ATO settlement, or if the ATO has assessed the arrangement as low risk after this guideline has come into effect.

In assessing the compliance risk in relation to the other risk zones, the level of profitability of the Australian operations and materiality of contract or project revenue are considered. References here are intended to refer to the entirety of the offshore drilling and associated activities of the operator in Australia, and to amounts resulting from those activities.

Green zone – low risk

Entities will be deemed to be low risk if the earnings before interest and tax (EBIT) margin is greater than 10.5 percent in the relevant income year. EBIT margin means earnings before interest and tax arising from the Australian operations, divided by the total contract revenue of the Australian operations.

Amber zone – moderate risk

Entities will be deemed to be moderate risk if the EBIT margin is less than 10.5 percent but greater than 5 percent in the relevant income year, or if the EBIT margin is 5 percent or less but the total revenue from all Australian contracts or projects is less than AUD 20 million.

Red zone – high risk

Entities will be deemed to be high risk if the EBIT margin is 5 percent or less in the relevant income year (and the total Australian contract revenue exceeds AUD 20 million).

ATO activity resulting from risk zone classification

The higher the risk rating, the more likely the arrangements will be reviewed by the ATO as a matter of priority. The resulting ATO activities depending on the risk zone classification are summarized below:

<table>
<thead>
<tr>
<th>Risk Zone</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>White</td>
<td>The risk assessment framework does not need to be applied but ATO activity will depend on the taxpayer’s particular circumstances; for example, if the taxpayer has an APA, an annual compliance review process will apply.</td>
</tr>
<tr>
<td>Green</td>
<td>The ATO generally will not apply compliance resources to the arrangement. Taxpayers will be eligible to access the simplified transfer pricing record-keeping (STPRK) option (it is not yet clear how this will be applied, since the current PCG on STPRK does not allow for application to these arrangements).</td>
</tr>
<tr>
<td>Amber or red</td>
<td>Being outside the low-risk zone means that the ATO considers that a taxpayer is at risk of obtaining a transfer pricing benefit. The ATO will prioritize compliance resources to deal with taxpayers involved in offshore drilling and associated activities that are assessed as having the highest risk of obtaining a transfer pricing benefit. Compliance approaches may include monitoring, risk reviews, and audits. There is a clear statement that taxpayers within the high-risk zones will not be precluded from entering into the APA program, but a greater level of transfer pricing documentation and evidence will be expected.</td>
</tr>
</tbody>
</table>

In addition, the draft PCG indicates that remission of penalties and interest may be available to taxpayers that engage with the ATO to transition their arrangements to the green zone, through voluntary disclosures, within a period of 12 months from the publication of the PCG.
Initial observations

Concerns regarding the ATO approach in this draft PCG include:

- A lack of transparency on the basis for the ATO-determined EBIT margins (“profit markers”) for the particular risk zones; and
- The rationale for the choice of an EBIT margin as an appropriate profit marker/“quasi-benchmark” for an operator of a MOBU (noting that for offshore arrangements such as marketing hubs, a “cost plus” ratio is used in the relevant PCG).

There are positives aspects to this draft; for example, the fact that the ATO has applied a "de minimis" level (the AUD 20 million revenue threshold) to a taxpayer's Australian operations, albeit this would only move a taxpayer to the moderate risk zone. However, given the value of the assets covered by the draft PCG and the substantial commercial day rates charged for their use, it is likely that this threshold will apply only in limited circumstances.

An additional improvement from prior PCGs is that, notwithstanding the risk rating, all taxpayers remain eligible for the APA program.

Taxpayers should be aware that the issues in this industry are complex and advice should always be sought before commencing or changing any arrangements.

Finally, it should be remembered that PCGs are not an interpretive view of the law; the prescribed EBIT margins are not safe harbor administrative concessions or profit expectations. Rather, they are simply elements of an ATO risk assessment framework. Moreover, taxpayers may take positions contrary to the draft PCG, provided they are supported by appropriate transfer pricing analysis and documentation.

Next steps

Comments on the draft PCG are due by 25 October 2019, with the guidance likely to be finalized shortly thereafter.

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Financial services transfer pricing: Bringing the tax dimension of banking reforms into focus

Basel III is the internationally agreed set of measures that was developed by the Basel Committee on Banking Supervision (BCBS) in response to the financial crisis of 2007-2008. The goal was to strengthen the regulation, supervision, and risk management of banks while enhancing the stability of the financial system overall.

The Basel III reforms were originally supposed to be introduced by the end of 2015. With repeated extensions, the BCBS’s target date for finalizing the Basel III banking reforms is now 1 January 2022.

URL: https://www.fsb.org/work-of-the-fsb/implementation-monitoring/monitoring-of-priority-areas/basel-iii/

This article explores three key changes relating to increased capital, liquidity, and counterparty risk requirements. Given the delayed implementation of Basel III, it is only now that the full impact of the measures (especially on the tax dimension) is becoming clear, and this article shares important insights for banking institutions.
**Basel III**

**Capital requirements:** Although a banking branch is technically part of the same legal entity as its head office, tax regulations require the attribution of capital between the head office and its branches. The rationale is that any branch requires a certain amount of funding to support the functions it performs, as well as the risks and assets that are being attributed to the branch for tax purposes. Such funding consists of free capital (that is, funding that does not give rise to an interest deduction) and interest-bearing liabilities.

The attribution of free capital to the branches determines the amount of interest-bearing liabilities that can be attributed, which in turn determines the level of interest deductions. Ultimately, this attribution of capital and interest-bearing liabilities determines the earnings before tax at the level of the banking head office and its foreign branches.

Many banks have already assessed the capital adequacy of their operations as a result of the implementation of Basel III. Some banks faced capital shortfalls and had to increase their affiliates’ capital position. Given the magnitude of the capital increases, these adjustments typically trigger a range of transfer pricing questions.

The key question is to what extent additional capital should be considered as part of the attribution of free capital between the head office and its branches. The Organisation for Economic Co-Operation and Development (OECD) recognizes under D-2 (v) 117 of the 2010 Permanent Establishment (PE) Profit Attribution Guidance that "[…] some business activities involve greater risks and require more free capital than other activities; hence the business activities undertaken through a PE may require proportionately more or less free capital than the enterprise as a whole."

URL: [https://www.oecd.org/ctp/transfer-pricing/45689524.pdf](https://www.oecd.org/ctp/transfer-pricing/45689524.pdf)

The OECD then states in D-2 (v) 117 that "[…] there will be instances where the PE conducts a very different type of business from the enterprise as a whole or there are differences in the markets that need to be considered in the free capital attribution."

This will require banking institutions to revisit their existing transfer pricing for the attribution of free capital ranging from the capital allocation, thin capitalization, and safe harbor approaches. This will also require them to determine an appropriate response on how to consider capital increases in the context of free capital attribution.

**Liquidity requirements:** The second key change of Basel III is higher liquidity requirements for banking institutions. One of the new requirements is the net stable funding ratio (NSFR), which aims to introduce more stable sources of funding. As a result, certain banking institutions already needed to inject longer-term funding into their banking affiliates to meet NSFR targets. This also triggers a range of complex transfer pricing questions on how to appropriately structure and price the provision of long-term funding in the intrabank context and how to align such funding transactions with existing funds transfer pricing (FTP) and treasury policies.

**Counterparty credit risk requirements:** The third key change triggered by Basel III is increased counterparty credit risk (CRR) measures. This affects banks when some affiliates (and their loan portfolio) are overly concentrated on one counterparty or group of counterparties. In practice, this forces affiliates to enter into guarantees (which are often internal) to transfer part of the counterparty credit risk to other banking affiliates. This again triggers complex transfer pricing questions on how to appropriately structure and price the provision of credit guarantees in the intrabank environment for tax purposes.

**Basel IV/CRD V**

The European Commission (EC) published a range of proposals for the transposition of Basel III (and already part of the future Basel IV framework) into EU law as part of the new Capital Requirements Directive V (CRD V). As part of the proposals, the EC considers introducing a requirement for banks to establish a centrally regulated and supervised entity (known as an Intermediate Parent Undertaking or IPU) for non-EU banking groups with significant EU activities (currently defined as at least EUR 40 billion).


CRD V is commonly regarded as an opportunity for European regulators to counter fragmented supervision by local regulators and the potential risk of regulatory and supervisory arbitrage in cases in which banking groups are subject to oversight by several local regulators.
This proposed IPU requirement is expected to put pressure on non-EU banking groups to revisit their legal structure and operating model, and consolidate their EU activities under a single IPU when there are two or more institutions established in the EU with the same ultimate parent. This includes the centralization of certain risk management functionalities in the new IPU (or an existing entity if designated as IPU).

This is expected to trigger another range of complex transfer pricing-related questions on how the centralization of risk management functions could impact existing transfer pricing policies (especially related to the attribution of profits, assets, and capital to IPUs vis-à-vis other banking subsidiaries/branches) and potential exit tax for the transfer of such functions.

The concern relates to the potential move of certain risk management functions to the IPU. The reason is that, in Chapter II of the 2010 OECD Guidance on the Attribution of Profits to PE, the OECD defines risk management as one of the two key functions (“key entrepreneurial risk-taking functions” or KERTs) “which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of individual risks and portfolios of risks.”

Together, these two KERT functions are typically relevant to the attribution of economic ownership of financial assets and the subsequent attribution of income and free capital. Any transfer of risk management functions could impact the existing location of KERT functions and as such affect the attribution of assets and income for tax purposes. If not addressed carefully, this could theoretically even result in a complex situation of split ownership of certain assets for tax purposes. This topic requires careful attention by tax departments and joint examination with the regulatory dimension to assess the potential impact.

Conclusion

The ongoing banking reforms and their impact on the tax position need to be carefully considered given the potential changes triggered by increased capital, liquidity, and counterparty risk requirements.

Tax departments of banking institutions should be actively involved in addressing these tax implications and work closely with management and other stakeholders on the implementation of banking reforms. It is important to ensure that any new transactions or dealings triggered by banking regulations, and which are subject to tax/transfer pricing rules, are appropriately identified, structured, priced, and documented.

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Bulgaria introduces mandatory transfer pricing documentation rules

Bulgaria on 13 August introduced mandatory transfer pricing documentation requirements effective 1 January 2020.

The new law, which amends and supplements the Bulgarian Tax and Social Security Procedure Code, was published in Issue 64 of the State Gazette dated 13 August 2019. The legislation also adopts the European Union directive that implements the mutual agreement procedure (MAP) as a mechanism for dispute resolution with regard to international double taxation.

The transfer pricing documentation requirement will enter into force as of 1 January 2020 and will apply to transactions entered into on or after 1 January 2020.

Scope

The new law provides that Bulgarian entities (including nonresidents that have a Bulgarian permanent establishment) must prepare a local file. Taxpayers that as of 31 December of the prior year did not exceed the following thresholds are exempt from the local file obligation:
• BGN 38 million (USD 21.5 million) in asset net book value; and
• BGN 76 million (USD 43 million) in net sales revenue; or
• An average number of 250 personnel for the reporting period.

Entities that are exempt from corporate taxation and those that are subject to alternative taxation under the Corporate Income Tax Act, as well as entities that enter into domestic related-party transactions only are exempt from the obligation to prepare a TP file.

There is no obligation to prepare a local file for controlled transactions with individuals, except for transactions with sole traders.

The local file must be prepared for transactions that exceed the following annual monetary thresholds:

- **Sale of goods:** BGN 400,000;
- **All other transactions:** BGN 200,000; and
- **Loans:** Principal of over BGN 1 million or interest and other revenues and expenses related to the loan of over BGN 50,000.

The listed thresholds are calculated separately for each controlled transaction. An exception is made when two or more transactions with one or more related parties are concluded under comparable conditions. In that case, the thresholds are calculated as the total value of those transactions. The local file should be prepared only for transactions that exceed the thresholds, although the taxpayer may be a party to other controlled transactions.

Entities that are obligated to prepare a local file and that are part of multinational entity (MNE) groups also must have a master file for the respective year, prepared by the ultimate parent entity (UPE) or another group entity.

For more information regarding the contents of the local file and master file, see Appendix 1 and Appendix 2 below.

**Due dates**

The local file must be prepared by 31 March of the following year (the same as the due date for filing the corporate income tax return), whereas the master file must be available by 31 March of the year after that deadline. For example, the local file for 2020 must be prepared by 31 March 2021 (with a possible extension until 30 September 2021 if an amended corporate income tax return is submitted), whereas the master file for 2020 must be available by 31 March 2022.

The local file must be prepared on an annual basis, but if there are no significant changes in the comparability factors, the analysis could be updated once every three years. The financial data for the comparable transactions or entities should be updated annually.

There is no requirement to submit the transfer pricing documentation to the tax authorities. The transfer pricing documentation (both the local file and the master file) should be kept by the taxpayer and provided to the tax authorities upon request.

**Penalties**

The new law imposes penalties for non-compliance with the requirements for preparation of documentation. A taxpayer that is obligated to prepare a local file and fails to do so may be subject to a penalty of up to 0.5 percent of the total value of the transactions that should have been documented. For loans granted or received, the total value of the transaction is the principal amount of the loans.

An entity that is required to provide a master file and fails to do so may be subject to a penalty between BGN 5,000 and BGN 10,000.

The penalty for providing incorrect or incomplete data in the transfer pricing documentation ranges from BGN 1,500 to BGN 5,000.
The amount of the penalties could be doubled in case of repeated failure to meet the requirements for preparation of transfer pricing documentation.

Comments

Despite the reduced scope of entities that must prepare mandatory transfer pricing documentation, the general requirement for taxpayers to prove the market nature of their transactions with related parties during tax checks and audits remains.

The tax authorities have a license to access Bureau Van Dijk’s specialized database – TP Catalyst – which allows them to make additional inquiries about comparable transactions or companies, as well as to conduct their own analyses. In this regard, we have observed heightened scrutiny in the review and analysis of transfer prices by the tax authorities during tax checks and audits.

Preparation of transfer pricing documentation will help businesses to manage the risk of adjustments to the tax result and accordingly, reduce the risk of the imposition of penalties, interest, and sanctions.

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Appendix 1: Local File Content

The following information must be included in the local file:

Information about the entity:

- A description (chart) of the management and organizational structure;
- Identification data of the entity’s owner/owners;
- Names and position of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices;
- A detailed description of the business and business strategy (including changes from the past year) pursued by the local entity, including an indication whether the local entity has been involved in or affected by business restructurings or intangible transfers, and an explanation of how these transactions affect the business of the person under Art. 71b, para. 1;
- Key competitors.

Information on the controlled transactions subject to the local file requirement:

- A description of the controlled transactions and the context in which such transactions take place, including their amount;
- An identification of the associated enterprises involved in the transactions and the relationship among them;
- The amount of intragroup payments and receipts for the transactions, broken down by type and tax jurisdiction of the payers and recipient;
- Copies of the intercompany agreements concluded by the local entity;
- A detailed comparability analysis, including the characteristics of the goods, services, financial assets or intangible assets, contractual term, economic conditions, description of the applied business strategies and functional analysis covering the person under Art. 71b, para. 1 and the respective related parties – parties in the controlled transactions, as well as the changes in the comparability factors from previous years;
- A description of the chosen transfer pricing method for determination of the arm’s length prices of the controlled transaction/s and the reasons for selecting that method;
- An indication of which related party is selected as the tested party (the party of the controlled transaction, in regard to which the chosen transfer pricing method is applied) and an explanation of the reasons for this selection;
- A summary of the important assumptions made in applying the transfer pricing method;
- An explanation of the reasons for performing a multiyear analysis;
- A list and description of selected comparable uncontrolled transactions (internal and external), if any, and information on relevant prices and/or financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information; the financial indicators are determined in accordance with the chosen transfer pricing method;
- A description of any comparability adjustments performed to achieve better comparability and an indication whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both;
- A description of the basis (allocation key) for allocation in cases of intercompany services and the reasons for choosing that basis (key);
- A description of the factors used to allocate the combined operating profit/loss when applying the profit split method, the reasons for choosing the relevant factors, and the method of determining the relative weight of each factor when more than one factor is used;
- A description of the reasons for concluding that, after applying the selected transfer pricing method, the results from the relevant controlled transactions are in line with Art. 15 of the Corporate Income Tax Act;
- A summary of the financial information (pricing and/or financial indicators) used in applying the transfer pricing method; and
- A copy of any existing unilateral and bilateral/multilateral advance pricing agreements (APAs) and other tax rulings to which the local tax jurisdiction is not a party and that are related to the controlled transactions described above.

**Financial information**

- Annual local entity financial statements for the fiscal year concerned;
- Information (excerpts and tables) and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements;
- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which the data was obtained.

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**Appendix 2: Master File Contents**

The following information must be included in the master file:

- A description and diagram/chart illustrating the MNE’s organizational structure, a list of all related parties in the group, as well as the jurisdictions in which each of them is resident for tax purposes, or, when not a resident of any jurisdiction, the jurisdiction under whose legislation it is created;
- A brief description of the MNE’s business(es), including:
  - Important drivers of business profit;
  - A description, chart, or diagram of the supply chain for the group’s five largest products, services, and/or intangible assets, offerings by turnover plus any other products and/or services amounting to more than 5 percent of the group consolidated turnover.
- A brief description of the related-party transactions, including:
  - Movements of goods, services, and/or intangible assets;
  - Movements of invoices;
  - Amounts of goods, services, and/or intangible assets.
- Related-party policy, applied within the group, or description of the group’s transfer pricing method that proves the arm’s length character of the prices of the controlled transactions;
- A brief description of important service arrangements between members of the MNE group, other than contracts for services in the field of research and development. The description must provide information about the capabilities of the main entities that provide these services, and the transfer pricing policies for allocating service costs and determining the prices to be paid for intragroup services;
- A description of the main geographic markets for the group’s products and services that are referred to in the second bullet point above;
• A brief functional analysis describing the contributions to value creation by individual entities within the group, that is, key functions performed, important risks assumed, and important assets used, as well as a description of the functional changes, if any, compared to the previous fiscal year;
• A description of important business restructuring transactions, acquisitions, and divestitures occurring during the fiscal year;
• A description of the business strategy, as well as any changes, that occurred compared to the previous taxable year;
• Information regarding intangible assets:
  o A general description of the MNE’s overall strategy for the development, ownership, and exploitation of intangibles, including location of principal R&D facilities and location of R&D management;
  o A list of intangibles (patents, IP, know-how, and others) or groups of intangibles that are important for transfer pricing purposes, and which entities legally own them;
  o A list of agreements among identified associated enterprises regarding the provision or transfer of intangibles, including cost contribution arrangements and R&D service agreements;
  o A general description of the group’s transfer pricing policies related to R&D and intangibles; and
  o A general description of transactions with intangibles between related parties during the taxable year, including accrued compensation, the related parties participating, the parties’ jurisdiction of residence for tax purposes (or for entities that are not resident of any jurisdiction, the jurisdictions under whose legislations they were created).
• Information related to the group’s financial intercompany activities:
  o A general description of how the group is financed, including important financing arrangements with unrelated parties;
  o The identification of related parties that have a central financing function for the group, including the country under whose legislation each of them is a resident for tax purposes, or, when it is not a resident of any jurisdiction, the jurisdiction under whose legislation it is created;
  o A general description of the MNE’s general transfer pricing policies related to financing arrangements between associated enterprises.
• The group’s financial and tax positions:
  o The group’s annual consolidated financial statement for the taxable year concerned; and
  o A list and brief description of any existing unilateral APAs and other tax rulings relating to transfer pricing issued to the related parties within the group.

Israel updates transfer pricing declaration form, but taxpayers may opt not to use it for 2018 reporting

The Israeli Tax Authority announced on August 1 that filing the updated Form 1385 is voluntary for reporting transactional information for 2018. However, filing the revised Form 1385 will be a mandatory requirement beginning with tax year 2019. Taxpayers that opt not to report using the updated Form 1385 for tax year 2018 are still obligated to file the legacy Form 1385.

Background


Israeli taxpayers are required to file the form, which details the intercompany transactions the company entered into during the prior year. The updated form includes several changes compared to the previous format. For example, taxpayers are now required to indicate whether the intercompany transaction amount is an income or an expenditure item from an Israeli perspective.

Taxpayers are now obligated to specify not only the transfer pricing method used for each intercompany transaction listed in accordance with Regulation 2(a), but also the rate of profitability, in accordance with Regulation 1, if the method specified in Regulation 2(a)(2)(a) is chosen (that is, a method that compares the profitability rate between the international transaction and the comparable transaction).
Taxpayers also must provide detailed information regarding the counterparty to each transaction listed, including name, tax identification number (TIN), and address.

Finally, taxpayers must now specify the income or expenditure amount regarding each transaction as it appears in the taxpayer’s financial statements.

Taxpayers have the option of declaring that a transaction is a one-time transaction in accordance with Regulation 4. Moreover, taxpayers may also declare transactions that, in terms of their classification and results, are subject to the safe harbor provisions of Income Tax Circular 12/2018. Specifically, this option is given in relation to three types of transactions in which services are provided by an Israeli entity to a foreign affiliate:

1. Services that add low value;
2. Low-risk distribution services; and
3. Marketing services, with regard to which the Israeli Tax Authority provides relief in reporting requirements.

The updated form requires that an officer of the Israeli taxpayer sign the form. Although the revised instructions that accompany the form do not mention personal liability, the implication of having a member of management sign the form is that this officer may be held personally accountable for the information provided.

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