Global Transfer Pricing

Arm's Length Standard

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In this issue:

OECD Holds Public Consultation on Intangibles

The OECD on November 12-14 held a much-anticipated public consultation on the intangibles discussion draft that was released in June, as well as on discussion drafts on transfer pricing safe harbors and timing issues in connection with transfer pricing. A select group of business representatives, government officials from both OECD member countries and invited observer countries, and OECD officials gathered to examine the issues that had been raised in the written comments submitted in September.

Not surprisingly, there were a significant number of comments. The draft issued in June 2012 was not a consensus document; it simply gathered the thoughts of the various member states at that time. As a result, there are inconsistencies within the document, imprecise wordings, and guidance that tries to give form to concepts that may not have been completely thought through, and that might not be appropriate. Nevertheless, this approach was welcomed by industry and advisors alike.

The definition of intangibles elicited much debate. Of all the comment submissions received, 56 percent included observations regarding the definition of intangibles; 42 percent thought the draft's approach was too broad. Discussion during the meeting showed that business representatives want a clear definition of "intangible," but not as currently formulated.

Business representatives argued that the draft focuses too heavily on anti-abuse concerns. They stressed that centralized IP holding structures are usually created for good commercial reasons, not "inappropriate" tax planning. Government and business representatives alike concurred that the role of the OECD Transfer Pricing Guidelines is not as an anti-abuse measure; that goal must be met by sovereign governments developing their own anti-avoidance regimes.

Discussion regarding the entitlement to intangibles-related returns revealed that the OECD's bold decision to release the discussion draft in interim form has led to one misunderstanding – many commenters interpreted the draft as endorsing the view that the funding of the intangible is not important. The OECD Secretariat clarified that it was not the drafters' intent to disregard financial investment in intangibles. However, the level of involvement (active v. passive) will be important in deciding the reward that should accompany that investment.

The use of financial valuation techniques did not lend itself to easy agreement among the participants. There was general agreement that any valuation method that is shown to both meet the arm's length standard and be accurate should be available to taxpayers. The taxpayer bears the burden to show that they have used the most appropriate method; the OECD Transfer Pricing Guidelines should not endorse or disavow any particular method.

The OECD's goal is to release a new discussion draft by early 2013.

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UN Releases Practical Manual on Transfer Pricing for Developing Countries

The United Nations Committee of Experts on International Cooperation in Tax Matters on October 15-19 adopted the *Practical Manual on Transfer Pricing for Developing Countries* during its eighth annual session. The UN Manual is a response to a need expressed by non-member countries of the Organisation for Economic Cooperation and Development for clear practical guidance on the policy and administrative aspects of the application of the arm's length principle for purposes of establishing transfer prices for transactions among related parties of a multinational enterprise. The UN Manual is intended to assist not only policy makers and administrators but also taxpayers in their dealings with tax administrations.

The UN Manual was drafted by the UN's Subcommittee on Transfer Pricing – Practical Issues, which was constituted in 2009 by the Committee of Experts. The subcommittee was asked to develop a practical mandate on transfer pricing to consider and reflect the practical realities for developing countries and MNEs, and to provide clear guidance in dealing with complex transfer pricing issues.[1]

Article 9 (Associated Enterprises) of the United Nations Model Double Taxation Convention between Developed and Developing Countries endorses the arm's length principle as defined in the OECD's Model Tax Convention on Income and on Capital.2 The foreword to the UN Manual expresses both the objective of achieving consistency with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 3 as well as "minimizing double taxation disputes with other countries, with their potential impact on how a country's investment 'climate' is viewed, while combating potential profit-shifting between jurisdictions where a MNE operates."4 As a result, the UN Manual is designed to reflect the arm's length principle for pricing transactions within multinational enterprises, with reference to the issues faced by developing countries, and the approach is practical rather than legislative.

The UN Manual is comprehensive – it includes almost 400 pages of guidance – in that it covers central policy, administrative, and technical issues. However, the preface makes it clear that the UN Manual would benefit from further, more detailed, work on issues such as the treatment of intangibles and services, and suggests an additional mandate for the subcommittee to continue its work on these areas. Moreover, while the UN has sought consensus as far as possible, there are some areas where consensus could not be reached.

Structure and Content of the UN Manual

The manual covers the following areas:

[1] The subcommittee is comprised of academics, representatives of various country governments, advisors, and industry representatives. The subcommittee met on five occasions (Kuala Lumpur, Malaysia in June 2010, New Delhi, India in February 2011 September 2011 in Tokyo, Japan February 2012 in Johannesburg, South Africa, and finally, in Shanghai, China in June 2012.) Throughout the drafting process and at every session extensive feedback was provided by various experts and stakeholders.
[2] Revised on July 22, 2010.
[3] Revised July 2010.
[4] UN Manual Foreword, paragraph 3. Available at: http://www.un.org/esa/ffd/tax/eighthsession/Foreword-20120928_v5_ML-accp.pdf

- Chapter 1 – Introduction
- Chapter 2 – The Business Environment
- Chapter 3 – The Legal Environment
- Chapter 4 – Building Capability
- Chapter 5 – Comparability
- Chapter 6 – Methods
- Chapter 7 – Documentation
- Chapter 8 – Audits
- Chapter 9 – Dispute Resolution
- Chapter 10 – Country Practices: Preamble, Brazil, China, India, South Africa
- Appendix I – Comparability Examples
- Appendix II – Documentation

Chapter 1 of the UN Manual provides an explanation and overview of transfer pricing, and addresses the practical issues and concerns of developing countries. Chapter 2 discusses multinational business operations, and Chapter 3 provides an overview of the transfer pricing regimes adopted globally from a legal perspective, and the various approaches to consider when developing transfer pricing laws. Chapter 4 focuses on the skills, resources, structures, and behaviors that tax authorities may require to successfully implement a transfer pricing regime, and on how requirements may change over time as a country develops. Chapters 5 and 6 (and Appendix I) provide a detailed discussion of acceptable transfer pricing methods and the associated need for, and challenges in obtaining, data to allow comparability with arm's length transactions. Indeed, comparability (especially a lack of access to local data on third-party transactions) is a hurdle to be overcome, particularly for some countries with small domestic markets. Chapter 7 (and Appendix II) discuss documentation requirements and penalties for failure to provide documentation, with reference to existing guidance and practice in this area. However, Chapter 7 also acknowledges that when a UN member country does not have an extensive tax treaty network, it will have to place greater reliance on taxpayer-provided information. Chapter 8 considers procedures for transfer pricing audits and in particular, the need for tax administrations to focus limited resources on cases which pose the highest risk of tax underpayments. In terms of guidance, Chapter 9 is the final chapter and sets out potential dispute resolution mechanisms for both domestic taxpayer/domestic tax authority and cross-border domestic tax authority/ foreign tax authority disputes.

Chapter 10 is different from the previous chapters. It does not reflect consensus (or near-consensus) views from the subcommittee members, but draws on the transfer pricing experiences – and therefore reflects the country-specific transfer pricing views – of Brazil, China, India, and South Africa, both on items covered in the broader text of the UN Manual as well as on matters not explicitly covered by the UN Manual. It should be noted that Brazil has not adopted the traditional arm's length principle approach to transfer pricing.

UN Manual and OECD Transfer Pricing Guidelines

As stated above, the UN Manual seeks consistency with the OECD Transfer Pricing Guidelines in applying the arm's length principle found in Article 9 of both the UN Model Convention and the OECD Model Convention. As a result, there is a fundamental consistency between the UN Manual and the OECD Transfer Pricing Guidelines. While there are some differences between the two, those tend to reflect differences in perspective and emphasis, rather than differences in the principles to be applied. Following the stated purpose of the UN Manual – to provide practical guidance to policymakers and administrators in developing countries on the application of the arm's length principle – the UN Manual seeks to follow the OECD Guidelines whenever possible. For example, the UN Manual specifies that documentation requirements should be as far as possible common between the UN Model Convention and the OECD Model Convention, because diversity in documentation rules could result in excessive compliance costs for companies.[5]

The UN Manual is stated to be a work in progress and, unlike the OECD Transfer Pricing Guidelines, does not currently have dedicated chapters on services, intangibles, cost contribution arrangements, and business restructuring. Moreover, the subcommittee's comments and positions as presented in the UN Manual were actually expressed in respect of the 1995 OECD Transfer Pricing Guidelines, and were not updated to reflect subsequent changes in the 2010 version of the Guidelines. This issues was brought forth during the February 2011 meetings of the subcommittee held in India, whereby the subcommittee stated that the committee does not have jurisdiction to determine whether the 2010 OECD Guidelines

[5] UN Manual, Chapter 1, paragraph 1.8.12

should be followed by the governments of developing counties and thus become the internationally agreed standards as described in the UN Manual.[6] It is not clear to what extent this would impact the objective of consistency.

Intangibles

Although the UN Manual does not yet include a chapter on intangibles, it does provide some commentary on the subject. The comments focus largely on marketing intangibles, and the issue of a subsidiary performing marketing activities and incurring expenses for a product trademark or brand name that is legally owned by a foreign affiliate.

The comments indicate that the UN Manual supports the concept of economic ownership, whereby the marketer that incurs significant marketing expenditures either adds value to the affiliate's intangible so as to obtain an economic ownership interest that entitles it to share in the profits of that intangible, or creates its own local marketing intangible for which it is entitled to be rewarded. The UN Manual seems to focus on the perspective of a marketer located in a developing country, and ensuring that it receives an appropriate level of return for its value-adding activities and the value of the marketing activities in that country.

The UN Manual's comments on this issue are not inconsistent with the current OECD Guidelines, but the attention given in the UN Manual to developing countries reflects its importance for countries like India and China, and signals that such countries can be expected to take an aggressive position in applying these guidelines.

Location-Specific Advantages

The UN Manual discusses extensively the concept of location-specific advantages, which includes location savings and other commercial or economic benefits derived from operating in a particular location. The UN Manual defines location savings as the net cost savings that a company realizes as a result of relocation to a low-cost jurisdiction (as a result of, for example, skilled labor, rent, and infrastructure). Such relocation of operations may give rise to location-specific advantages (LSAs) such as easy access to specialized manpower, proximity to market, or a large customer base with high purchasing power. When a multinational enterprise successfully exploits the LSAs, the incremental profit derived is termed "location rent." The OECD Transfer Pricing Guidelines indicate that the allocation of these benefits normally depends on the functions, assets, and risks of each party, and on their bargaining powers. Consistent with this approach, the UN Manual states that an arm's length allocation of these benefits depends on competitive factors relating to access to the benefits, and on alternatives available to the parties given their relative bargaining power.

The UN Manual also states that location savings may be offset at times by "dis-savings," which are higher costs incurred, for example, on account of poor infrastructure or high transportation costs. The UN Manual cautions that location savings do not always automatically lead to location rent, and the principal company may be forced to pass on the savings to the ultimate customer to be competitive in pricing.

As MNEs increasingly outsource their manufacturing or services functions to low-cost jurisdictions, determining the arm's length price of the potential "location savings" is attracting the attention of tax authorities globally. Countries like China and India, which offer low costs and other significant local market advantages, will likely be particularly concerned about the taxing implications arising from distribution of these benefits within an MNE.

Lack of Comparables

The UN Manual recognizes that there can be problems in obtaining reliable comparables data, because there is commonly either a lack of reliable local comparables or an inability to access public data on uncontrolled comparables. Accordingly, while the use of comparables from the same geographic market is generally preferred, the UN Manual supports a flexible approach to searching for comparables, including the use of foreign comparables. It also recognizes the potential for geographic market differences affecting the reliability of foreign comparables, and the need to make reliable comparability adjustments to take into account any such differences.

[6] Letter to the Financing for Development Office of United Nations Department of Economic and Social Affairs from the Permanent Representative of India to the United Nations, No. PMI/NY/152/2/2012. Paragraph 3.2

Similarly, the OECD Transfer Pricing Guidelines recognize that geographic markets are an important comparability factor, and that while foreign comparables can be used, reasonably accurate adjustments are needed to account for any geographic market differences.

Both the UN Manual and the OECD Transfer Pricing Guidelines indicate that the difficulty of making reasonably accurate and reliable adjustments to account for geographic market differences will affect the appropriateness of a pricing method that relies on foreign comparables data. The Chinese country report in the UN Manual states that this may require the use of a profit split method. It is apparent from the UN Manual that problems with availability of reliable comparables data may mean that a profit split is commonly viewed as the most appropriate method by tax authorities.

Risk Allocation

Globalization has led MNEs to establish R&D, contract manufacturing, and back-office operations in many countries to take advantage of low-cost labor markets. These operations often take the form of limited-risk structures where local entities are insulated from business risks and are compensated on a net costs plus basis.

The UN Manual states that in many countries the availability of independent comparables is limited and the use of foreign comparables may therefore be necessary. The UN Manual explicitly recognizes the need for comparability adjustments, including risk adjustments. It goes on to state that there is no universally accepted method for risk adjustment and most statistical methods have their limitations.

In the absence of comparables, the UN Manual adopts the same economic substance test as the OECD Transfer Pricing Guidelines for evaluating whether the allocation of risk between associated enterprises is arm's length, indicating that control over risk and the financial capacity to bear the risk are important factors in this regard. The Manual provides practical examples to test the claims of foreign associated enterprises located in developed countries that they exercise control over R&D activities performed by subsidiaries based on the ability to make strategic decisions, to bear the risk of unsuccessful R&D, to monitor the associated enterprises' activities, and to control the overall budget.

The UN Manual includes examples similar to those found in the OECD Transfer Pricing Guidelines to illustrate scenarios whereby the risk of R&D activities is considered controlled either by a parent company or by the subsidiaries that actually perform the activities. These examples are likely to be useful for developing countries in challenging the risk allocation under contract R&D and other service arrangements, and in arguing that a profit split method is more appropriate than rewarding the subsidiary merely with a cost plus return.

Country-Specific Considerations

India – On the issue of location savings, the India country report states that MNEs operating in India not only enjoy location savings but also generate "location rent." The main issue, as far as the Indian Transfer Pricing Administration is concerned, is the quantification and allocation of location savings and location rent among the related entities, for which a profit split method can be used when the functional analysis and the relative bargaining power would be important factors for consideration. The Indian Transfer Pricing Administration believes the benefit of location savings will not be taken into account by using local comparables, but rather can only be computed by taking into account cost differences between a low-cost and a high-cost jurisdiction.

Regarding risk allocation, the Indian Transfer Pricing Administration challenges the ability of foreign principal entities to exercise control remotely, and states that most foreign entities are unable to submit documents in support of their claim of exercising control. The Indian Transfer Pricing Administration contends that Indian entities undertake core R&D activities, strategic operational decisions relating to budgets, and the design and direction of R&D activities, and thus control substantial part of the risks. In such cases, the allocation of routine cost-plus returns to Indian entities will not be considered to be at arm's length.

The report highlights the difficulty of finding comparable transactions involving intangible assets in the public domain, and emphasizes that Indian associated enterprises need to be compensated for intangibles created through extraordinary advertising, marketing, and promotion expenses beyond what an independent local distributor would incur. Compensation could take the form of reimbursement of excessive expenditures, along with a mark-up or an arm's length return for the development of marketing intangibles.

On the issue of adjustments to comparable data, the report states that it is possible to address accounting differences, differences in capacity utilization, and intensities in working capital, but that it is extremely difficult to make risk adjustments in the absence of reliable internationally agreed methods. With respect to providing risk adjustments using the capital asset pricing method, the Indian Transfer Pricing Administration believes the method is flawed and may not provide accurate results.

The India report also provides the Indian tax authorities views on issues such as intragroup services and financial transactions. In relation to intragroup services, the Indian Transfer Pricing Administration asserts that most principal entities globally do not allow any profit mark-up for services rendered by Indian entities, or in exceptional cases, allow low mark-ups on a restricted cost base. On the other hand, when Indian entities are receiving services, MNEs charge high mark-ups on all services, including shareholder services and duplicate services. In relation to financial transactions, the Indian Transfer Pricing Administration highlights the challenges faced because of the lack of availability of specialized databases to handle such complex transactions.

China – The China country report discusses location savings in relation to its electronics manufacturing, luxury goods, and automotive industries. The Chinese Tax Administration relies on an adjusted cost plus mark-up to calculate an arm's length result for contract R&D centers. To determine the additional profit attributable to location savings, the Chinese Tax Administration computes the difference in cost base between the Chinese taxpayer and the average cost base of foreign companies before applying an arm's length markup rate that is determined using comparable data.

On the issue of risk allocation, the Chinese country report asserts that often the principal entity determined to be responsible for the R&D is found to have neither the technical expertise nor the financial capacity to control the associated risk. Moreover, a risk-based approach may place insufficient emphasis on the fact that sizeable assets and the majority of the headcount are located in China, with few management personnel located in the foreign entity that claims to control the risk. In such situations, a net cost plus approach would not be appropriate; rather, the tax authorities would consider a profit split approach or a contribution analysis more suitable.

The report states that marketing intangibles and LSAs are often closely integrated, as developing countries provide access to a fast-growing market to help MNEs monetize the value of such intangibles. As a result, consideration is necessary to properly compensate each entity for its contribution. Issues such as the associated enterprises' entitlement to additional profits for improvement of the original intangibles or process-related know-how and marketing intangibles identified through excessive operating expenses-to-sales ratios are addressed by the Chinese State Administration of Taxation by employing a profit split method or performing comparability adjustments when the TNMM is used.

The report notes that a key challenge regarding the issue of comparability is the lack of reliable public information on comparable companies. The use of foreign comparable would require significant adjustments to the comparable data, and in some cases may require a different methodology, such as a profit split, because no reliable comparability adjustments are feasible.

The China report also touches on practical challenges to applying the arm's length principle when a Chinese entity relies on its related parties for both input purchase and output sales. In such cases, the SAT's approach is to start with the general presumption that the related-party purchase of materials is at arm's length, and evaluate the reasonableness of the mark-up earned by the contract manufacturer on its cost base. The rationale for accepting the related-party purchase price is that Chinese Customs would check the value of imports and safeguard against unreasonably low intercompany purchase prices. In another example, the China report describes the challenges to determine the proper return for a toll manufacturer, given that there are only a few independent listed companies available that perform such activities. In such a situation, the SAT's approach is to determine the return for a contract manufacturer and then adjust for factors such as inventory carrying costs to arrive at the profit for the toll manufacturer.

Brazil – The Brazilian country report explains that the use of transactional profit methods is not permitted under the country's transfer pricing legislation. With specific reference to the cost plus method and the resale price method, the law establishes fixed margins for gross profit and mark-up that are specified by the Ministry of Finance across various sectors, instead of relying on independent comparable transactions. The Brazilian report discusses the strengths and weakness of the fixed margin rules, which are designed for simplicity and to facilitate ease of administration and compliance, not necessarily to foster a fair and flexible system and maximum compatibility with the arm's length principle. The Brazil report also provides guidance to countries considering adopting the fixed margins system. It recommends that tax authorities do extensive pricing research on public databases prior to specifying a fixed margin and determine a statistical range of tolerance that is then verified by taxpayers or groups that represent them.

The Brazilian rules prescribe methods for computing arm's length prices that are different from the methods approved by the UN Manual. Because the Brazilian rules do not adopt the arm's length principle, MNEs with Brazilian operations have to evaluate their potential tax exposure and develop a special transfer pricing plan to defend and optimize their overall international tax burden.

South Africa – The South African country report states that in many instances, unique dynamics exist in the South African market that enable subsidiaries of foreign associated enterprises to realize higher profits than are evidenced by comparable data obtained from foreign databases. Accordingly, building on the practices of India and China, the South African tax authority – SARS – is currently considering approaches to location savings.

On the reliability of comparable data and adjustments, the report states that the main challenge encountered in determining arm's length profits is the lack of domestic comparable data and reliance on European databases to establish arm's length price. In practice, SARS has attempted to make complex comparability adjustment for geographic differences; however, those are made with caution and in specific circumstances.

The report presents a unique transfer pricing challenge in relation to the sale of intangibles, on account of the exchange control regulations that prohibit relicensing of intangible property once sold outside of South Africa. In these situations, the foreign associated enterprises that become the legal owners of the intangible assets relicense the intangible worldwide, earning a royalty, whereas the South African entity continues to perform functions in relation to the development of intangible for a cost plus return. As a result, disputes arise on issues of economic versus legal ownership, allocation of a share of the profits on the sale of intangibles, and the valuation of the intangibles.

The South African country report emphasizes the challenges faced in accessing important information from the taxpayer while conducting audits. The report also touches on management charges paid out by South African entities, and the difficulty in determining whether the intercompany service has provided economic and commercial benefit to the recipient based in South Africa.

Significant Issues for Future Updates of the UN Manual

The treatment of intangibles remains an important topic in transfer pricing that the UN Manual touches upon, but there is no chapter exclusively dedicated to an in-depth discussion and detailed guidance on the treatment of intangibles. The subcommittee has acknowledged the importance of intangibles and will address the issue in more detail in future updates, once the OECD finalizes the discussion draft on intangibles released in June 2012. Similarly, the UN Manual mentions intercompany services and business restructuring throughout the report, but does not dedicate individual chapters to those significant issues. Cost sharing arrangements and advance pricing arrangements (APAs) are mentioned in passing, but again, are not detailed in separate chapters. Accordingly, the UN Manual is seen as a work in progress and will be significantly updated in future phases.

Conclusion

Taxpayers are well advised to intensify and streamline their transfer pricing documentation requirements and pay attention to issues such as allocation of risks between entities, location savings and location-specific advantages. The UN Manual stresses that additional consideration should be paid to the particular attractiveness a market may offer to companies doing business in that market, and the subsequent turnover generated from activities there. This aspect is emphasized more than in the OECD Transfer Pricing Guidelines. This might encourage tax authorities to exercise broadened powers on ongoing transactions and thereby increase the risk of double taxation.

The Indian, Chinese, and South African country chapters broadly reflect the UN Manual and the arm's length principle it embodies, while highlighting the implementation challenges faced locally. While there is no complete harmony between the country-specific views and those expressed by the subcommittee in the first nine chapters of the UN Manual, many of the differences expressed seem to arise from the tension that dominates transfer pricing issues between developed and developing countries, and others that have not been addressed in the current draft of the UN Manual. Nevertheless the publication of the UN Manual provides taxpayers with a new level of understanding of the evolving transfer pricing practices of various countries and enables tax administrations to frame effective legislation more effectively.

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Australian Government Releases Exposure Draft of New Transfer Pricing Legislation

As part of the process of reforming Australia's transfer pricing rules, the government on November 22 released an exposure draft of legislation to replace the current transfer pricing provisions in Division 13 of the Income Tax Assessment Act 1936.

This legislation is the second stage of the government's announced reform process. The first stage was completed in September with the enactment of Subdivision 815-A of the Income Tax Assessment Act 1997, prescribing "treaty-equivalent cross-border transfer pricing rules" whose primary purpose is to ensure that the transfer pricing articles in Australia's tax treaties can be applied as an assessment power independent of Division 13.

The latest exposure draft legislation is for new Subdivisions 815-B, 815C, 815-D, and 815-E of the ITAA 1997. Division 13 will be repealed when the new provisions are enacted. Subdivision 815-A has retroactive effect (from 1 July 2004), but will have no prospective operation from the date of application of the new changes.

According to the government, the purpose of Division 815 is to bring Australia's rules more into line with international best practice, and to help the country protect its tax base. In announcing the reforms in November 2011, the government referred to recent court decisions, including the *SNF Australia* case, suggesting that Australia's existing rules could be interpreted in a way that is out-of-sync with international norms. The *SNF Australia* decision casts doubt on the validity, under Division 13, of transfer pricing adjustments proposed by the Commissioner that rely on profit methods. The case also questioned the status and relevance of the OECD Transfer Pricing Guidelines in Australia.

Key features of the new provisions are:

- Subdivision 815-B, which modernizes Division 13 as it applies to separate legal entities, is broadly drafted to ensure that the amount taxable in Australia as a result of cross-border conditions between entities reflects the arm's length contribution made by Australian operations. This is unlike section 136AD of Division 13, which is drafted in terms of arm's length pricing of (i.e., consideration for) transactions.
- Unlike Division 13, which operates only through the Australian Tax Office Commissioner's determination, Subdivision 815-B requires taxpayers to self-assess their taxable profits by applying the arm's length principle. Like section 136AD of Division 13, 815-B provides only for adjustments to increase taxable profits.
- Like section 136AD of Division 13, 815-B applies regardless of whether the parties are "related" or not, allowing the ATO to attack collusive behavior between unrelated parties that results in a reduction of profits in Australia. Like Subdivision 815-A, 815-B explicitly requires that it be interpreted consistently with the OECD Transfer Pricing Guidelines, and incorporates the OECD-approved methods and comparability factors.
- Subdivision 815-B contains an express requirement to have regard to the economic substance of the transactions entered into in identifying the arm's length conditions for those transactions, and allows the ATO to potentially reconstruct transactions when the arrangements are not considered "substantially similar" to what would have occurred between independent parties, given the options realistically available to the Australian taxpayer.
- Subdivision 815-C, which modernizes Division 13 as it applies to permanent establishments (PE), confirms the relevant business activity approach (also known as the single-entity approach), under which the arm's length principle is applied to attribute an entity's actual income and expenses to its PE, as the basis for attributing profits under Australia's domestic transfer pricing rules. The Board of Taxation is currently conducting a review to report to the government by April 2013 on the implications of adopting a functionally separate-entity approach as now endorsed by the OECD.

- Subdivision 815-D links contemporaneous documentation evidencing application of the arm's length principle to the current transfer pricing penalty regime; otherwise taxpayers will not be able to establish a reasonably arguable position in relation to that pricing. It also applies some new *de minimis* thresholds.
- The current unlimited time period for making transfer pricing adjustments is replaced with an eight-year limit.

Some aspects of the exposure draft are controversial, notably, the explicit focus on economic substance and the apparent inconsistency with the OECD's position that reconstruction of transactions by tax authorities is allowable only in exceptional circumstances. The proposed legislation allows reconstruction by the ATO when it is considered that the taxpayer would not have entered into the transactions given the options realistically available to it, and when a substantially similar arrangement would not have been entered into by independent parties. This will likely put a heavy burden on taxpayers not only to consider the price of intragroup transactions but also the associated terms of the transaction, and will undoubtedly introduce uncertainty for taxpayers and the ATO alike as to how this test would be applied in practice.

While the removal of unlimited time periods for amendments will be welcomed, it is unclear why an eight-year limit is required, leaving timing for transfer pricing adjustments significantly out of step with other time limits for income tax. This is particularly the case given all of the information readily available to the ATO in reviewing taxpayers' transfer pricing arrangements.

It is clear that the ATO can be expected to continue with renewed vigor its targeting over recent years of business restructurings, intragroup financing arrangements, and recurrent loss-makers.

The period for submissions on the exposure draft closes on 20 December 2012.

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Irish Revenue Outlines Transfer Pricing Compliance Review Program

The Irish Revenue on November 26 issued guidance for its proposed Transfer Pricing Compliance Review (TPCR) Program.

Ireland introduced a formal transfer pricing regime for companies within the charge to tax in Ireland on their trading activities for accounting periods beginning on or after 1 January 2011. The first corporation tax returns for companies subject to the new regime were filed in September 2012.

Transfer Pricing Review Program

The TPCR program will allow authorized officers from the Irish Revenue to send out notifications to selected taxpayers inviting them to self-review their transfer pricing and report back to the Irish Revenue within three months. The review will be for a specific accounting period.

The report to be provided to the Irish Revenue based on this self-review will address:

- The group structure;
- Details of transactions by type and associated companies involved;
- Pricing and transfer pricing method for each transaction or group of transactions;
- Functions, assets, and risks of the parties involved;
- List of documentation available or reviewed by the taxpayer; and
- The basis for establishing if the arm's length standard has been satisfied.

In most circumstances, an existing transfer pricing study should suffice. Under the Irish transfer pricing regime, counterparty documentation can suffice when it contains sufficient information relating to the Irish operations and transactions undertaken.

Once the TPCR report is submitted within the prescribed time frame to the Irish Revenue, a post-review letter will be issued. Either no further enquiries will take place or issues will be identified that require further consideration and discussion, to be addressed within the TPCR process. The fact that further enquiries are to be addressed *within the TPCR process* should mean that a formal audit still will not have begun, and that any additional tax will be treated as arising from an unprompted disclosure carrying only mitigated penalties.

Commentary

The proposed new TPCR process should not pose a significant additional burden on taxpayers within the remit of Ireland's transfer pricing regime, in particular when transfer pricing documentation is already in place covering all the requirements outlined above. In addition, the time frame of three months should provide taxpayers with adequate time to ensure that the information required can be gathered and made available.

It should be noted that the process is not a formal tax audit, and that the taxpayer will have the opportunity to make a tax disclosure before any formal audit notification. Such audit notification may commence when the outcome of the TPCR process is not satisfactory from the Irish Revenue's viewpoint.

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Supreme Court of Canada Hands Down Partial Victory for Glaxosmithkline, but Saga Continues

The Supreme Court of Canada (SCC) on October 18 issued its long-awaited decision on the GlaxoSmithKline Inc. case, concluding that both the Crown's appeal and Glaxo Canada's cross-appeal should be dismissed, and reaffirming the decision by the Federal Court of Appeal (FCA).

The SCC found that a proper application of the arm's length principle requires consideration of other relevant intercompany transactions, and sent the case back to the Tax Court of Canada (TCC) to redetermine the arm's length price on that basis.

While this decision confirms that intercompany transactions should not be priced independently of other relevant intercompany transactions, it leaves open to interpretation a number of questions on how this is to be achieved in practice.

Background

The *Glaxo* case involves the transfer pricing for the purchase of ranitidine, a patented active pharmaceutical ingredient used to combat stomach ulcers. Ranitidine was discovered by Glaxo Canada's parent company located in the United Kingdom (Glaxo UK) in 1976, and was determined to have superior properties to existing anti-ulcer medications available at that time. Glaxo UK branded the drug that incorporated ranitidine as "Zantac." Zantac was approved for sale in Canada in 1981, and was launched by Glaxo Canada in 1982. Given its superior properties, Glaxo was able to price Zantac at a premium and still capture a significant market share.

During the relevant taxation years, Glaxo Canada marketed Zantac under a license agreement between Glaxo Canada and Glaxo UK. The license agreement covered the entire Glaxo product portfolio, not just Zantac. The license agreement provided Glaxo Canada with the right to manufacture, use, and sell proprietary products; the right to use trademarks (including Zantac); access to new products and improvements; marketing and product registration materials; and the right to have a related party provide raw materials. Glaxo Canada purchased ranitidine from a related party located in Switzerland, Adechsa S.A. From 1990 to 1993, Glaxo Canada paid over $1,500 per kilogram for ranitidine.

Prior to February 1993, a compulsory licensing system existed in Canada under which generic versions of patented pharmaceutical products could be marketed (subject to compliance with normal approval and registration requirements) in exchange for a 4 percent royalty payable to the patent owner. Generic products would typically be launched at a price point lower than that of branded drugs. Two companies began selling generic versions of ranitidine products in Canada in 1987 and 1989, respectively. Those two companies purchased the ranitidine required for their generic drugs from suppliers that they dealt with at arm's length. From 1990 to 1993 the prices that the generic companies paid for ranitidine were typically less than $300 per kilogram.

The Canada Revenue Agency (CRA) adjusted the transfer prices paid by Glaxo Canada for ranitidine for the 1990 to 1993 tax years under subsection 69(2) of the Income Tax Act (ITA) (the predecessor to the current transfer pricing rules in section 247) to the highest amount paid by the generic companies for ranitidine. The CRA's adjustment increased Glaxo Canada's taxable income by C $51 million. Subsection 69(2) provided that the amount paid to a related nonresident person cannot be more than the amount "that would have been reasonable in the circumstances if the nonresident person and the taxpayer had been dealing at arm's length."

Lower Court Decisions

Tax Court of Canada Decision – Glaxo Canada appealed the CRA's assessment to the Tax Court of Canada. The TCC trial was conducted in the first half of 2006, and the decision rendered on May 30, 2008.

At trial, the CRA's position was that the generic companies' purchases of ranitidine from arm's length manufacturers were comparable transactions, and that the arm's length price could not exceed this amount. Glaxo Canada's position was that the generics were not an appropriate comparable, because its business circumstances were different from those of the generic companies, and because the ranitidine purchased by the generic companies was not manufactured to the same standard. Glaxo Canada's arguments were based on the position that its license and supply agreements with Glaxo UK and Adechsa should be considered together in establishing a reasonable price. The Crown argued that the license agreement should not be taken into consideration in determining the price for the ranitidine.

The TCC determined that "according to the evidence, the only item of value received by Glaxo Canada under the Supply Agreement was ranitidine." The TCC then concluded, based on prior court decisions, that the Supply Agreement with Adechsa and the License Agreement with Glaxo UK covered separate matters, and should be considered independently. On this basis, the TCC decided in favor of the CRA, setting the price for ranitidine at the amount paid by the generic companies with only a small adjustment of $25 per kilogram for incremental manufacturing performed by Adechsa.

Federal Court of Appeal Decision – Glaxo Canada appealed the TCC decision to the Federal Court of Appeal (FCA) on the basis that the trial judge erred in the determination of what circumstances were relevant to establishing "the reasonable amount" under subsection 69(2) of the ITA. Glaxo Canada argued that the real test is whether "*any reasonable person*, standing in the appellant's shoes but dealing at arm's length with Adechsa, would have paid the amount paid by the appellant." Glaxo's position was, in essence, that the price was reasonable in light of the ability to sell the finished product as the branded drug Zantac, as well as in light of other factors such as access to Glaxo's other products.

The FCA concluded that the trial judge had indeed erred in concluding that the license agreement with Glaxo UK was an irrelevant consideration. The FCA agreed with Glaxo Canada's argument that the correct test to apply is whether any reasonable person would agree to pay the amount that was paid to Adechsa. The FCA noted that while anyone might be able to buy ranitidine at market prices from a willing seller, the business reality was that if such a purchaser wanted to market the finished product as Zantac and obtain a price premium, the license agreement was "a circumstance" that had to be taken into account. On this basis, the FCA concluded that the TCC judge made an error of law in determining that the generic price was the appropriate price under subsection 69(2) of the ITA. The FCA therefore referred the matter back to the TCC for a determination of the correct arm's length price, taking into account the circumstances of the license agreement.

Appeals to the Supreme Court

The Crown's Appeal – The Crown appealed the FCA's decision to the SCC. In its appeal, the Crown argued that the search for an arm's length price must focus on the particular good, the particular transaction, and the particular parties to that transaction. The Crown asserted that the reasonable business purpose test, which was developed in the context of other provisions in the ITA, was ill suited to resolving transfer pricing matters. The Crown argued that this test, as adopted by the

FCA, requires the Minister of National Revenue to accept circumstances (such as the license with Glaxo UK) as they are, whereas, according to the Crown, the legislation should be viewed as requiring the minister to ignore such non-arm's-length circumstances. The Crown further argued that the FCA's approach would be at odds with that of other OECD member countries, resulting in significant uncertainty.

Glaxo Canada's Cross Appeal – Glaxo Canada appealed the FCA's decision, arguing that the FCA erred in referring the matter back to the TCC to reascertain the arm's length price taking into account the appropriate circumstances. Glaxo Canada's position was that it had successfully demolished the minister's assessment of tax, and it was therefore inappropriate to have the matter reheard on the basis of an alternative approach. Having concluded that the minister's assessment was not correct, the FCA should have set the assessment aside.

Supreme Court Decision

The SCC concluded that both the Crown's appeal and Glaxo Canada's cross-appeal should be dismissed, sending the transfer price determination back to the TCC. The Court agreed with the previous FCA decision that a proper application of the arm's length principle requires regard for "economically relevant characteristics," and that this includes consideration of other transactions that impact the transfer price under consideration, in this case the License Agreement. The SCC found that Glaxo Canada may have paid for some of the rights and benefits conferred to it under the License Agreement through the prices paid to Adechsa for ranitidine, and that considering the License and Supply agreements together "offers a realistic picture of the profits of Glaxo Canada."

While noting that the OECD's 1979 and 1995 Transfer Pricing Guidelines "are not controlling" since they are not statutory provisions, the SCC nonetheless relied on these guidelines in arriving at its decision. Although the "reasonable in the circumstances" test of subsection 69(2) of the ITA has since been replaced with an "arm's length" test in section 247, the issues are common to both.

The SCC also concluded that the arm's length price for the ranitidine must still be determined, and that this will require an examination of the circumstances arising from the License Agreement that are linked to the Supply Agreement. It referred this determination back to the TCC, while providing the following additional guidance:

1. Transfer pricing is not an exact science and "some leeway must be allowed." The Court goes on to say that "as long as a transfer price is within what the court determines is a reasonable range, the requirements of the section should be satisfied." This point is important in that it supports the widely held view that arm's length prices should be determined on the basis of reasonable ranges, which is not inconsistent with the CRA's own guidance on the subject.
2. In assessing the evidence, the "respective roles and functions of Glaxo Canada and Glaxo Group should be kept in mind," and the "transfer pricing should not result in a misallocation of earnings that fails to take account of these different functions and the resources and risks inherent in each." While it is not entirely clear, the SCC in this instance appears to use "Glaxo Group" to refer to Glaxo UK as well as the global group of companies under it. As such, it is not clear whether the guidance is suggesting earnings should not be misallocated between Glaxo Canada and *all* other related parties taken as a whole, or whether the guidance is suggesting that there should not be a misallocation of earnings to any individual Glaxo entity.
3. The SCC reminds the TCC that the interests of each party to the transaction must also be considered. This is a core element of the arm's length principle and consistent with the OECD Transfer Pricing Guidelines and CRA guidance. In particular, the Court suggests that reasonable economic alternatives of the parties to the transaction must be considered in the determination of transfer prices.
4. The fact that arm's length distributors have acquired ranitidine from a Glaxo Group supplier at higher than generic prices should be considered. While this guiding point is specific to the Glaxo facts, it also serves as a reminder that other arm's length arrangements should be considered in guiding a comparability analysis or transfer pricing determination, even if those specific arm's length arrangements are insufficiently comparable to be relied on outright.

Conclusion

The SCC decision provides some needed clarity for taxpayers and their advisors in the area of "bundled" transactions. However, it leaves the more difficult part – the actual determination of an arm's length price – to the TCC. The guidance provided may be difficult to apply based on the facts that have been previously argued at the lower courts, and taking into account that most of the relevant time period is more than 20 years old.

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Selecting Discount Rates in the Application of the Income Method

The U.S. Treasury Department on December 22, 2011, published in the Federal Register the final U.S. cost sharing regulations (Treas. Reg. 1.482-7).[7] The emphasis placed by the Internal Revenue Service on the use of the income method as the best method to analyze platform contribution transactions (PCTs) has resulted in tremendous pressure on taxpayers and practitioners to come up with practical methodologies to reliably estimate the cost of capital to be used to value the expected operating income stream in the cost sharing alternative and in the licensing alternative, respectively.[8] Although the final regulations recognize that those two costs of capital may be different, little practical guidance is provided.[9]

The object of this article is to provide a succinct, nonmathematical discussion of the relationship that *has* to exist in a meaningful and internally consistent application of the income method (as specified in the final regulations) between the cost sharing alternative and licensing alternative discount rates. This discussion is based on extensive analyses recently published by the author in the following two articles: "The 2012 IRS Cost Sharing Regulations Examined: An Argument For Focusing on the Intangible Development Costs Discount Rate," *21 BNA Transfer Pricing Report 11, 10/4/2012* and "The Mathematics of Cost Sharing Under The Income Method," *21 BNA Transfer Pricing Report, 13, 11/1/2012*.

Analysis

Why should the cost of capital used to discount the expected income stream in the cost sharing alternative be different (presumably higher) than that used to discount the expected income stream in the licensing alternative? The typical answer to that question generally invokes the development risks involved in the intangible development activities (IDA) as the primary reason to assign an additional risk premium to the cost sharing alternative discount rate.[10]

Because the outcome of research and development (R&D) activities is risky, investors require – and competitive markets provide – a premium to compensate for the financial losses that are bound to occur when the R&D efforts fail to produce a marketable product. Or so the story goes.

Despite sounding appealing and intuitively correct, this story is fundamentally flawed and violates well-accepted basic principles in the corporate finance literature. The reason the story is flawed is that the risk of success or failure in most R&D activities is uncorrelated with the level of economic activity. Consider, as an example, a pharmaceutical company that invests large amounts of money over a long period of time to develop a chemical compound into a marketable FDA-approved drug. The development risks the company faces include the very high risk that the drug will not meet the standards of safety and efficacy necessary to receive FDA approval. Failure to receive FDA approval translates into a loss of the entire R&D investment. Since the safety and efficacy of a chemical compound has absolutely nothing to do with the overall state of the economy, or with the movements in value of a well-diversified portfolio of market securities, the systematic risk of this investment is close to zero, and hence the appropriate discount rate for this development activity is arguably close to the risk-free rate (or the cost of debt in the case of default risk) – regardless of how risky the development itself is. Once, or if, a marketable drug has been developed, that is when systematic risk (that is, co-movements with the market) will affect the cash flow of exploiting the drug; by that time the development risk has ceased to exist.

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[7] REG 144615-02, T.D. 9568, 76 Fed. Reg. 80082, December 22, 2012.
[8] For the remainder of this article, we will use the words "cost of capital" and "discount rate" interchangeably, depending on the context.
[9] *See* for example Treas. Reg. §1.482-7(g)(2)(v) and in particular Treas. Reg. §1.482-7(g)(2)(v)(B)(1); Treas. Reg. §1.482-7(g)(4)(vi)(F); and Treas. Reg. §1.482-7(g)(4)(vi)(F)(*1*).
[10] IDA can consist of a single project or investment under development, or of a portfolio of various projects or investments under development.

The view that only the systematic risks (if any) introduced by the intangible development costs (IDC) will justify a difference in discount rates used in the cost sharing alternative and in the licensing alternative seems consistent with the positions taken by the Treasury in the final regulations. Consider, for example, Treas. Reg. §1.482-7(g)(4)(i)(F):

> *"…In circumstance where the market-correlated risks as between the cost sharing and licensing alternatives are not materially different, a reliable analysis may be possible by using the same discount rate with respect to both alternatives."*

Further consider Treas. Reg. §1.482-7(g)(4)(vi)(F)(1):

> *"…The difference, if any, in market-correlated risks between the licensing and cost sharing alternatives is due solely to the different effects on risks of the PCT Payor making licensing payments under the licensing alternative, on the one hand, and the PCT Payor making cost contributions and PCT Payments under the cost sharing alternative, on the other hand."*

By emphasizing that it is the difference in *market-correlated* risk between the two alternatives that drives the difference in discount rates, and that absent any material difference in market-correlated risk between the two alternatives, the discount rate could be equal, the final regulations appear to embrace the traditional corporate finance view that only systematic risk receives a risk premium.

So if development risk is not the reason why the cost of capital used to discount the expected operating income in the cost sharing alternative should be higher than that used to discount the expected cash flow in the licensing alternative, what can that reason possibly be? A useful clue is found in the final regulations; indeed Treas. Reg. §1.482-7(g)(2)(v)(B)(1) states that:

> *"In some circumstances, a party may have less risk as a licensee of intangibles needed in its operations, and so require a lower discount rate, than it would have by entering into a CSA to develop such intangibles, which may involve the party's assumption of additional risk in funding its cost contributions to the IDA."*

Taken literally, this excerpt from the final regulations suggests that the discount rate used to value the cost sharing alternative could be equal to the discount rate used to value the licensing alternative, plus a risk premium that reflects the risk of funding the IDC. Notice that Treas. Reg. §1.482-7(g)(2)(v)(B)(1) makes no mention of a risk premium related to the likelihood of success or failure of the IDA. As will be demonstrated below, the final regulations got it right; it is indeed the operating leverage created by the IDC that magnifies the systematic risk in the expected operating income of the cost sharing participant. The greater the operating leverage created by the IDC, the greater the spread between the cost of capital of the levered firm (cost sharing alternative participant) and of the unlevered firm (licensing alternative participant). This result is identical to the well-known and well accepted result in the corporate finance literature that, *ceteris paribus*, the systematic risk of a leveraged firm is higher than the systematic risk of an unleveraged firm.[11] The greater the financial leverage created by the interest payments, the greater the spread between the cost of capital of the leveraged firm (the firm with debt and equity) and the cost of capital of the unleveraged firm (the firm with no debt and all equity).

The close analogy between financial leverage and operating leverage is good news for transfer pricing practitioners faced with the practical issue of determining reliable and supportable discount rates. Indeed, since the work of Modigliani and Miller (1958) on the one hand and Hamada (1972) on the other hand, a vast theoretical and empirical literature has developed around the construction of discount rates for leveraged firms, in reference to the discount rates applicable to unleveraged firms. Recognizing that operational fixed costs are very similar to interest payments to debt holders, a smaller, but more directly relevant literature subsequently developed around the relationship between a firm operational fixed costs and its asset beta.[12] The starting point of that literature is the segregation of a firm total costs into variable and fixed costs. Since, by definition, fixed costs have a zero beta, the appropriate discount rate for these fixed costs is the risk-free rate of return – which is the rate of return assumed on debt in the traditional Hamada (1972) formula. Therefore, it should not be surprising that the result that a leveraged firm will have greater systematic risk than an unleveraged firm carries over to the

[11] We will use the terms "leveraged firm" and "unleveraged firm" to describe firms with and without financial leverage, respectively, and use the terms "levered firm" and "unlevered firm" to describe firms with and without operating leverage, respectively. This language will eliminate the need to specify each time which type of leverage (financial or operational) we are considering.

[12] *See,* for example, Lev (1974).

analysis of operationally levered firms. Various corporate finance textbooks offer some version of a Hamada-type formula relating the beta of a levered firm to that of an unlevered firm.[13]

Although instructive and useful, the operating leverage literature goes only so far to analyze the impact of the assumption of IDC funding on the systematic risk of the levered firm. This is because we do not want to assume that IDCs are perfectly fixed costs, and because they are the *only* costs that should be analyzed to support the existence of magnified systematic risk in the cost sharing alternative.[14] We will show that it is easy to generalize the textbooks formula (derived to analyze purely fixed costs) to a formula that allows IDCs to not be purely fixed costs, and that focuses exclusively on IDCs and not on any other type of costs, whether variable, fixed, or in between, since those are present in both the licensing and the cost sharing alternatives.

The cost sharing alternative participant can be thought of as an unlevered firm, namely, the licensing alternative participant, accepting the operating leverage of IDC, thus becoming a levered firm. The relationship between the cost sharing alternative discount rate and the licensing alternative discount rate therefore boils down to establishing the relationship between the systematic risk of a levered firm and the systematic risk of an unlevered firm. As discussed above, a vast literature exists to guide us in deriving that relationship; we thus proceed to demonstrate that it takes the form of a simple formula – referred to as Penelle (2012), closely analogous to the Harris & Pringle (1985) formula for de-leveraging and re-leveraging equity beta in the case of financial leverage under the assumptions of risky debt and the value of the tax shield of interests discounted at the cost of equity of the firm.[15] The formula is:

Penelle (2012)[16]

$$r_t^{CSA} = r^L + (r^L - r^{IDC}) \times \frac{PV_t(IDC_i, r^{IDC})}{PV_t(OI_i, r^L) - PV_t(IDC_i, r^{IDC})}$$

In the previous expression, r_t^{CSA} denotes the cost sharing alternative discount rate, r^L denotes the licensing alternative discount rate, r^{IDC} denotes the IDC discount rate (cost of debt), OI_i denotes the operating income of the cost sharing participant (pre-IDC), and PV_t denotes the present value operator. This critically important formula states that the cost sharing alternative discount rate is equal to the licensing alternative discount rate plus a non-negative risk premium equal to the product of the systematic risk premium of the business $r^L - r^{IDC}$ multiplied (magnified) by the operating leverage created by funding the IDC. Since the IDC and the operating income pre-IDC are provided in the financial projections, developing meaningful projections is critical, because the implied operating leverage drives the delta between the two relevant discount rates (the cost sharing alternative discount rate and the licensing alternative discount rate). It should be clear from Penelle (2012) that the presence of operating leverage *does not create* risk the controlled foreign participant would not face as a licensee; the presence of operating leverage merely *magnifies* risk the controlled foreign participant would face as a licensee and for which it would receive a return $r^L - r^{IDC}$ from the market.

Notice that this formula is derived by imposing present value *accounting equalities* and present value *weighted average cost of capital equalities*. This means that any violation of the previous formula means that either accounting equalities or weighted average cost of capital equalities are violated – breaking the required internal consistency of the application of the income method.

An exactly analogous formula exists linking the rate at which to discount the expected operating income of the licensor in the licensing alternative – called the *differential income stream* in the proposed and temporary regulations of December 2011, to the licensing alternative discount rate.

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[13] *See,* for example, Pratt & Grabowski (2010) and Brealey, Myers, & Allen (2008). These textbook formulae deal with the effect of perfectly fixed costs, and thus assume a zero beta for those fixed costs.
[14] *See* Treas. Reg. §1.482-7(g)(4)(i)(C).
[15] Mathematically, those assumptions combine to eliminate the value of the tax shield of debt in their beta de-leveraging and re-leveraging formula, which ends up not having the tax rate as an argument (most other such formulas do).
[16] The proof of the formula can be found in Philippe G. Penelle, "The Mathematics of Cost Sharing under the Income Method", *21 BNA Transfer Pricing Report, 13, 11/1/2012*.

Penelle (2012)[17]

$$r_t^{IP} = r^L + (r^L - r^{IDC}) \times \frac{PV_t(IDC_i, r^{IDC})}{PV_t(R_i^L, r^L) - PV_t(IDC_i, r^{IDC})}$$

In the previous expression, r_t^{IP} denotes the differential income stream discount rate, r^L denotes the licensing alternative discount rate, r^{IDC} denotes the IDC discount rate (cost of debt), R_i^L denotes the gross income of the licensor in the licensing alternative (pre-IDC), and PV_t denotes the present value operator. Since the gross income of the licensor in the licensing alternative is always lower than the operating income (pre-IDC) of the controlled foreign participant in the cost sharing alternative, the operating leverage of the licensor in the licensing alternative will always be greater than the operating leverage of the controlled foreign participant in the cost sharing alternative. It thus follows that the four relevant discount rates always satisfy the following inequality:

$$r_t^{IP} \geq r_t^{CSA} \geq r^L \geq r^{IDC}$$

Under which circumstances are different discount rates required to value the expected operating incomes in the cost sharing alternative and in the licensing alternative? Penelle (2012) illustrates that Treas. Reg. §1.482-7(g)(2)(v)(B)(1) should probably have read "*in almost all circumstances…*", as any beta strictly less than one for the IDC will result in magnified systematic risk for the levered firm (cost sharing alternative participant) compared to the unlevered firm (licensing alternative participant) – this simply means that IDCs are not perfectly variable costs. The IRS's withdrawal of the 2007 Coordinated Issue Paper thus appears to be the right move, because Example 1 incorrectly assumed the cost sharing alternative discount rate and the licensing alternative discount rate to be the same, violating the fact that legitimate IDCs *cannot possibly* be perfectly variable costs.

Penelle (2012) also illustrates why early-stage development firms tend to face higher and less stable over time costs of capital than more mature firms, *ceteris paribus*. These early-stage development firms will initially face greater operating leverage than more mature ones, because they will have relatively lower levels of expected revenue per dollar of IDC. As time goes by and revenue is expected to increase (per dollar of IDC), the level of operating leverage decreases and so does the cost of capital. Similarly, the formula illustrates why we do not find too many firms that develop intellectual property and rely exclusively on licensing to generate their revenue. Indeed, by exploiting the intellectual property themselves and capturing the routine return associated with the manufacturing and distribution functions, firms can decrease the level of operating leverage they face, and thus decrease their cost of capital.[18] This point was illustrated analytically in the two versions of Penelle (2012), one for r_t^{CSA} and one for r_t^{IP}, by noting that the gross income of the licensor in the licensing alternative is always lower than the operating income (pre-IDC) of the controlled foreign participant in the cost sharing alternative. Since the resulting operating leverage faced by the controlled foreign participant in the cost sharing alternative is therefore always lower than the operating leverage faced by the licensor in the licensing alternative, its cost of capital is therefore always lower.

The last comment is a great segue into describing, from an economics standpoint, what a cost sharing arrangement is really all about. There are those who believe that a cost sharing arrangement is about shifting the development risk (risk of project failure) from a U.S. parent company to a controlled foreign corporation, and compensating the controlled foreign corporation for the risk of development failure it agrees to take on. This view is economically flawed. Cost sharing arrangements are about *de-levering* the financial statements of the U.S. parent company as a licensor (by removing the IDC obligation), and *levering* the financial statements of the controlled foreign participant (by introducing the IDC obligation). This swap of an obligation to pay a purely variable cost as a licensee (the royalty) to an obligation to pay a fixed cost as a cost sharing participant (the IDC) has a market price, namely, the difference between the cost sharing alternative discount rate and the licensing alternative discount rate. As demonstrated in Penelle (2012), this market price is exactly equal to the magnification of the systematic risk borne by the controlled foreign participant (as a licensee), resulting from the obligation to fund the IDC (as a cost sharing participant). The risk of failure of the development activity associated with the IDC is irrelevant.

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[17] The proof of the formula can be found in Philippe G. Penelle, "The Mathematics of Cost Sharing under the Income Method", *21 BNA Transfer Pricing Report, 13, 11/1/2012*.

[18] This is the reason why the proposed and temporary regulations of December 2011 addressing the differential income stream discount rate – which is really the discount rate at which to discount the operating income of the licensor in the licensing alternative – has very little practical use. Indeed, applying that methodology would require observing in the market place the cost of capital of companies that do not exploit any of the intellectual property they develop, and rely entirely on licensing income. The suggested methodology is thus limited to the extent that such companies exist and can be found.

Our analysis also underscores the fact that developing an intangible asset, within the meaning of Treas. Reg. §1.482-4(b), is *not* an economic requirement to justify a return in excess of a perfectly competitive return (e.g., a CPM return). What is economically required to justify a return in excess of a perfectly competitive return is the existence of fixed costs – whether or not those fixed costs fund the creation of an intangible asset is irrelevant. Fixed costs magnify the systematic risk of the routine business. Therefore, any market participant funding those fixed costs *will* receive a return in excess of a perfectly competitive return (an economic rent), since a perfectly competitive return provides an appropriate return on variable costs *but not enough return* to cover the fixed costs.[19]

Conclusions

Although the law draws a clear distinction between cost sharing arrangements and licensing arrangements, the underlying economics of both types of arrangements are exactly the same; thus, the governing valuation principles that apply to both should be the same. The theory outlined herein applies not only in the context of the income method pursuant to Treas. Reg. §1.482-7, but also in the context of the income method as an unspecified method pursuant to Treas. Reg. §1.482-4.

Developing and exploiting intellectual property requires funding fixed costs that in a cost sharing arrangement are distributed between the two parties in different proportions than in a licensing arrangement.[20] However, in both cases, *some* of those fixed costs will presumably be borne by the foreign party, whether as a licensee or as a transferee. The only economically relevant question is *what proportion* of those fixed costs will create operating leverage, and thus magnify existing systematic risk, in the financial statements of the foreign party. Once that question has been answered, the valuation technique discussed in this article can be implemented by plugging the appropriate numbers in Penelle (2012). It is the delta between the resulting cost of capital applying to the operating income of the foreign party pre-fixed costs versus post-fixed costs that will dictate the proportion of intangible income the foreign party is entitled to as a reward for agreeing to take on the funding of those fixed costs and facing the resulting magnified systematic risk.

The takeaway from this article for taxpayers and transfer pricing professionals should be that a thorough analysis of the nature of the costs associated with developing and exploiting intangibles is required to perform a meaningful valuation of a cost sharing or licensing transaction. Focusing on an analysis of the riskiness of the intangible development activity itself is unproductive, because that analysis will have no bearing on the valuation. What will have a definite bearing on the valuation, however, is the level of operating leverage the cost sharing or licensing transaction introduces in the financial statements of the transferee or licensee, respectively. The need for that analysis can no longer be overlooked by practitioners.

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[19] Perfectly competitive returns are achieved by profit-maximizing firms facing a perfectly elastic demand when they produce a level of output such that marginal cost is equal to the price they face (no market power). This results in a loss in the presence of fixed costs. Perfect competition is thus inconsistent with a market with perfectly elastic demands and the presence of fixed costs. Profit-maximizing firms facing fixed costs will produce at a level of output where marginal cost is equal to marginal revenue, which requires some inelasticity in the demand they face (some level of market power). The resulting price markup over marginal cost is what provides the return to the fixed costs. In other words, the presence of fixed costs creates barriers to entry and the resulting market structure cannot be perfectly competitive.

[20] Typically, in a licensing arrangement, the U.S. parent company will bear *all* the fixed costs associated with the development of the intangibles, and the controlled foreign licensee will bear *all* the incremental fixed costs associated with the exploitation of the intangibles. In contrast, in a cost sharing arrangement, the controlled foreign participant will typically bear *all* the fixed costs associated with both the development and the exploitation of the intangibles. Under U.S. law, nothing prevents a licensing transaction to provide that the licensee will bear *some* of the costs associated with the development or maintenance of the intangibles, thereby increasing the proportion of fixed costs the licensee agrees to fund, and thereby justifying leaving a greater portion of the intangible return to the licensee.

Latvia Introduces Transfer Pricing Documentation Requirements

Latvian corporate taxpayers (both resident companies and permanent establishments of foreign companies) will be required to submit transfer pricing documentation effective 1 January 2013.

The documentation requirements will be triggered if a company's annual turnover exceeds LVL 1 million and the value of its related-party transactions exceeds LVL 10,000. The transfer pricing documentation requirements will apply to transactions with:

- Foreign related companies;
- Latvian companies that qualify for group relief;
- Companies that benefit from tax relief;
- Related individuals; and
- Companies that operate in or are established or set up in low-or no-tax jurisdictions.

The following information must be included in the documentation:

- An industry analysis that includes a general description of the industry in which the taxpayer operates;
- A company analysis that contains relevant information about the company, such as strategy, forecasts, and legal and operational structure;
- A functional analysis that includes a description of the functions, risks, and assets employed by the parties to the transaction;
- The method selected to establish the market price; and
- An economic analysis based on the transfer pricing method selected and that contains an analysis of financial data or values of transactions between comparable unrelated companies.

Taxpayers will be required to maintain the transfer pricing documentation for five years and to provide the documentation to the tax authorities within one month of receiving a request. If not all the required information is provided, or if the taxpayer fails to submit the documentation in a timely manner, the tax authorities can establish the market price for the transaction based on the information available.

Taxpayers will have the option to enter into advance pricing agreements with the tax authorities to negotiate the market price for the relevant transaction if the value of the transaction – or its planned value – exceeds LVL 1 million during the year.

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Hungarian Tax Authorities' Transfer Pricing Audit Practices Examined

The growing significance of transfer pricing audits in Hungary is reflected in the increasing number of reviews conducted, and the growing tax adjustments made by the Hungarian tax authorities (NAV). This article outlines our recent experience concerning NAV's transfer pricing audit practices. Interestingly, NAV confirmed our opinion regarding the audit and advance pricing arrangement (APA) procedures in an article it published in the August 2012 issue of the journal *Adóvilág* ("Search for comparable data when using non-designated methods for determining arm's length prices").

Annual Update

In an increasing number of cases, NAV has made it clear that it expects an annual update of the database search/arm's length range presented in the transfer pricing report for the previous year. Although this requirement is not clear in the transfer pricing decree, NAV has imposed default penalties in cases when the database search/arm's length range documentation was not updated. NAV representatives confirmed this approach during various discussions. Given the size of the default penalties, taxpayers should consider preparing the generally simple and brief updates.

Arm's Length Price Range

Under NAV's definite and consistent approach, the interquartile range – the middle 50 percent of research results – is considered generally to constitute the arm's length range in the case of a database search. In cases when the margin earned by the party through the transaction under review is not within the interquartile range, or if the interquartile range is not chosen as the arm's length range, a reasonable explanation is required to avoid a transfer pricing adjustment. In exceptional cases, the entire range may be accepted as the arm's length range. Part of the problem is that NAV's audit practice is ambiguous regarding which section of the range or prices – the spread range (average or median) or some closer extremes of the range – should be adjusted in the event of a transfer price adjustment.

It should be noted that if the price chosen is not within the interquartile range, a tax inspection is likely. If NAV accepts only the interquartile range as the arm's length range after the tax review, it has the right to propose an adjustment, which will probably be closer to some middle value farther away from the price applied, rather than the extreme of the range.

Hierarchy of Methods

NAV's approach, in line with the revised 2010 OECD Transfer Pricing Guidelines, is clear that the comparable uncontrolled price method (CUP) has priority over other designated methods if conditions for reliable adoption exist. Therefore, taxpayers should ensure that when the transfer pricing report presents the arm's length nature of the price using a method other than the CUP, the report explicitly addresses the reasons why the CUP method could not be used.

Search for Comparable Data

NAV is increasingly focusing on the verifiability of data used for determining arm's length prices and is reviewing the research results through a cross-check with the AMADEUS database; in the case of other databases, the tax authorities have requested a copy of the research results. The need for reproducibility might raise complaints regarding the online versions of various databases; as a further complication, reliable data sources other than the online databases are unavailable in many cases, and their disqualification from the process would make it practically impossible to determine the arm's length range. It is therefore recommended to document the research process with particular care to be ready to satisfy the verifiability requirement in a tax audit. It is advisable to ensure that accurate details of the database used are included in the report, and that every important step is recorded.

Selection of Comparative Data – Is further certification of data obtained from AMADEUS or other company databases necessary? Since in our experience none of the databases is flawless, we believe – and the tax authority's official position confirms – that a manual cross-checking of the extracted data (for example, regarding owners, activities, etc.) with other data sources might prove extremely helpful and, therefore, is highly recommended. But such an examination following the software database search is highly time-consuming and represents an unreasonable burden for the taxpayer. It varies from one audit to another whether the tax inspector accepts the comparative analysis without a subsequent qualitative check, although the tax authority's practice seems to imply that a manual qualitative elimination will be necessary in the future. Therefore, we recommend a review of database searches presented in transfer pricing reports, with particular emphasis on the required detail.

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