Global Transfer Pricing

Arm's Length Standard

Month/Month 2013

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OECD Releases First Base Erosion and Profit Shifting Report

The Organization for Economic Cooperation and Development on February 12 released its first report on base erosion and profit shifting (BEPS). The report responds to the growing perception that governments lose substantial corporate tax revenue because profits are shifted to favorable tax locations, and that traditional international tax principles may no longer be adequate for countries to develop appropriate responses to BEPS.
URL: http://www.oecd.org/ctp/BEPSENG.pdf

The 91-page report was presented at the February 15-16 meeting of G-20 finance ministers and central bank governors in Moscow.

The goal of this first report is to establish the case for action by showing the extent of base erosion and profit shifting. If the G-20 agree that a problem exists and that action is needed (which is likely) the OECD group will then consider work streams that will be undertaken to address the problem. The current plan is to present those work streams to the G20 in June 2013. The plan will (i) identify actions needed to address BEPS, (ii) set deadlines to implement actions, and (iii) identify the resources needed and the methodology to implement these actions.

The report concludes that BEPS is a significant problem for OECD member and non-member states, and that "the international common principles drawn from national experience to share tax jurisdiction may not have kept pace with the changing business environment."

The report states that domestic rules and internationally agreed standards for sharing tax jurisdiction were developed in the early 20th century. They are grounded in a business environment typified by a lower degree of economic integration across borders, and are unsuited to current business models characterized by high intellectual property value and rapid information and communication systems.
The areas of concern for the working group are:

- International mismatches (double nontaxation);
- OECD model treaty concepts in the field of digital delivery for goods and services;
- Tax treatment of related-party debt, insurance, and other intragroup financial arrangements;
- Transfer pricing, in particular the shifting of risks and intangibles, the artificial splitting of assets between different legal owners, and transactions within a group that would rarely take place with third parties;
- The effectiveness of domestic anti-avoidance measures (general anti-avoidance rules, controlled foreign corporation regimes, thin capitalization) to prevent treaty abuse; and
- The availability of harmful preferential regimes.

The report challenges governments to address this perceived problem both globally and in a holistic manner, including consideration of matters such as source-based and residence-based taxation. The report recognizes that individual governments cannot act alone to address these issues.

The goals of the OECD BEPS group are to:

- Neutralize the effect of mismatches;
- Improve or clarify transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective. The current Working Party 6 intangibles work is only a part of this;
- Update solutions to the question of tax jurisdiction, particularly in relation to digital goods and services. This might require revision to the model treaty;
- Propose more effective anti-avoidance measures to be included in domestic law or international guidance;
- Draft rules on the treatment of intragroup finance transactions, including deductibility and withholding taxes; and
- Propose solutions to counter harmful regimes more effectively, taking into account transparency and substance.

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IRS Releases 2012 MAP Statistics, Revealing Increase in Inventory and U.S.-Initiated Cases

The Internal Revenue Service on March 13 released its mutual agreement procedure (MAP) statistics for the 2012 fiscal year. In contrast to data presented by the IRS in prior years, the 2012 statistics include only data for double tax cases, with advance pricing agreements (APAs) now tracked separately by the IRS Advance Pricing and Mutual Agreement Program (APMA), which was formed in the first quarter of the 2012 fiscal year.[1]

Two key trends revealed by the IRS MAP statistics are an increase in U.S.-initiated cases presented to the IRS and Competent Authority, and a significant increase in U.S.-initiated transfer pricing cases (51 cases in 2012, compared to 25 in 2011). These trends may be the result of increased taxpayer awareness and acceptance of MAP as an effective way to resolve double taxation, with the 2012 statistics highlighting that in over 95 percent of cases, U.S. taxpayers received full double tax relief through MAP. However, with the restructuring of the APMA in 2012 and increased U.S. transfer pricing enforcement, it is likely that the trend toward more U.S-initiated cases will accelerate in the next few years. This is consistent with public comments by senior IRS officials that indicate an expectation that the percentage of U.S.-initiated adjustments to foreign-initiated adjustments will increase going forward.

APMA Director Richard McAlonan has indicated that a significant factor in the increased inventory is the current impasse between the U.S. and Indian competent authorities, because U.S. taxpayers continue to file U.S./India double tax cases, but those cases are not currently being negotiated or resolved by the two governments. Nevertheless, the IRS is still accepting double tax cases arising from Indian-initiated adjustments and U.S. taxpayers are still required to seek competent authority assistance through the MAP process to (1) obtain double tax relief from Indian-initiated adjustments; (2) take advantage of

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[1] The IRS's APA statistics were released by APMA in Announcement 2013-17 on March 25, 2013, and show that a record-breaking 140 APAs were executed during the 2012 fiscal year. Additional detail and commentary about the APA statistics for 2012 will be provided in the next issue of *Arm's Length Standard*.

the memorandum of understanding between the United States and India to stay the demand of Indian domestic tax while the MAP process is pending; and (3) protect the creditability of Indian tax payments.

Highlights of the 2012 MAP statistics include the following:

- Over 95 percent of the cases resolved were settled with full double tax relief: the majority of settlements resulted in relief by withdrawal of the original adjustment (63.59 percent), compared with the provision of correlative relief in 32.40 percent of cases. This is consistent with the outcomes on a five-year average basis, with 53.89 percent of cases resolved by withdrawal of the original adjustment compared with 35.74 percent of cases resulting in the provision of correlative relief.
- Only 2.17 percent of cases were closed without double tax relief, with taxpayers receiving partial relief in an additional 1.84 percent of cases. The five-year average results (2008-2012) are slightly higher (6.73 percent and 3.64 percent, respectively) as a result of aberrations in prior years.
- The number of transfer pricing cases received by the IRS that related to foreign-initiated adjustments decreased in 2012 (130 in 2012 compared with 141 in 2011), as did the number of cases arising from foreign-initiated adjustments that were resolved (74 in 2012 compared with 119 in 2011). The former statistic is somewhat surprising, given the recent emphasis the IRS has placed on creditability of foreign taxes arising from foreign-initiated adjustments, most recently articulated by Michael Danilack in his role as the U.S. Competent Authority. Danilack has continued to emphasize the need for U.S. taxpayers to protect their foreign tax credit positions by taking advantage of the competent authority process in the case of foreign-initiated transfer pricing adjustments, and the authors would expect this to be reflected in current and future MAP statistics.
- The processing time for transfer pricing double tax cases decreased in 2012 (from a combined average of 849 days in 2011 to 790 days in 2012) to a five-year low in the period from 2008. In particular, a significant decrease in the processing time for U.S.-initiated cases is evident from the statistics (an average processing time of 704 days in 2012 compared with 859 days in 2011). The average processing time for foreign-initiated cases decreased from 847 days in 2011 to 809 days in 2012. This increased momentum can be largely attributed to the formation of APMA and the increased staffing available to actively manage and process double tax cases. Increased coordination between APMA and the IRS field is also likely to have had an impact on the marked decrease in processing times for cases arising from U.S.-initiated adjustments.
- Nonallocation, permanent establishment, and limitation on benefits cases continued to be processed quickly in 2012, with a total of 55 cases received in 2012 and 50 cases disposed of. Consistent with this, the average processing time in 2012 was 638 days. Notwithstanding these statistics, we understand that there are some withholding tax cases in which competent authority negotiations are moving slowly as a result of differences in treaty interpretation between the IRS and certain treaty partners.

Overall, the 2012 MAP statistics are very positive for U.S. taxpayers, and trends toward faster processing of cases by the APMA team are expected to continue. Looking forward, it is anticipated that cases arising from foreign-initiated transfer pricing adjustments will continue to be a significant but declining proportion of IRS inventory.

As the IRS emphasis on the creditability of foreign taxes continues, U.S. taxpayers under foreign audit should take care not to acquiesce to foreign-initiated adjustments, and in particular should be aware of certain situations that Danilack recently indicated should be brought to the attention of the U.S. Competent Authority:

- When a foreign tax authority offers to substantially reduce an adjustment on the condition that the taxpayer not seek competent authority assistance; and
- When a foreign authority asks for excessive documentation, such as passports of U.S. employees who performed a service, before it will allow a deduction for the U.S. charges.

With changes to the current IRS Competent Authority revenue procedure (Rev. Proc. 2006-54) expected in 2013, Danilack has indicated that under the new revenue procedure the IRS may permit cases resulting from self-initiated adjustments or taxpayer voluntary disclosure into the IRS competent authority process. This will be a welcome relief for taxpayers with transfer pricing exposures arising from genuine errors or mistakes in prior years that they cannot correct without exposure to double taxation. However, it is likely that those situations will be considered on a case-by-case basis, and taxpayers should seek advice about their specific facts before taking action that may preclude their ability to seek competent authority relief.

U.S. taxpayers that are under tax or transfer pricing audit in foreign jurisdictions, or that have a reasonable expectation they may be subject to a foreign tax audit, should be mindful of treaty timelines to request competent authority relief or notifications, and take all necessary protective measures to preserve their rights to seek competent authority relief. Taxpayers do not need to wait until the conclusion of a transfer pricing audit to take such measures. Failure to notify the IRS (or foreign tax authority) within the specified time frames will likely preclude the taxpayer from seeking competent authority relief from double taxation, which could give rise to issues regarding the creditability of foreign taxes. *See* Procter & Gamble Co. v. U.S., (S.D. Ohio, Case No. 1:08-cv-00608, defendant's motion for summary judgment granted 7/6/10).

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Philippines Issues Long-Awaited Transfer Pricing Regulations

The Philippines' Secretary of Finance, upon the recommendation of the commissioner of Internal Revenue (CIR), has issued Revenue Regulations (RR) No. 2-2013 dated January 23, 2013. The regulations provide guidelines on the arm's length principle for transfer pricing, which applies to both cross-border and domestic transactions between associated enterprises.
URL: ftp://ftp.bir.gov.ph/webadmin1/pdf/68122RR 2-2013.pdf

The guidelines are largely based on the arm's length methods set out under the Organization for Economic Cooperation and Development (OECD) transfer pricing guidelines and adopts the arm's length principle as the most appropriate standard to determine transfer prices of related parties.

Arm's Length Principle

The arm's length principle requires that transaction with a related party be entered into under comparable conditions and circumstances as a transaction with an independent party. It is founded on the premise that when market forces drive the terms and conditions agreed to in an independent party transaction, the pricing of the transaction would reflect the true economic value of the contributions made by each party to the transaction. Essentially, this means that if two associated enterprises derive profits at a level above or below the comparable market level solely by reason of the special relationship between them, the profits will be deemed non-arm's length. In such a case, the tax authorities may make the necessary adjustments to the taxable profit of the related parties in their jurisdiction so as to reflect the true value that would otherwise be derived on an arm's length basis.

RR 2-2013 provides a three-step approach for the application of the arm's length principle:

- Step 1 – Conduct a comparability analysis;
- Step 2 – Identify the tested party and the appropriate transfer pricing method; and
- Step 3 – Determine the arm's length result.

Available Arm's Length Methods

In determining the arm's length result, any of the following methods may be used:

- The comparable uncontrolled price method (CUP);
- The resale price method (RPM);
- The cost plus method (CPM);
- The profit split method (PSM); and
- The transactional net margin method (TNMM).

Although the Bureau of Internal Revenue (BIR) does not provide a specific preference for any one method, the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be utilized. To ensure that taxpayers clearly reflect their income attributable to related-party transactions and to prevent the avoidance of taxes on those transactions, the regulations recognize the authority of the CIR to distribute, apportion, or allocate gross income or deductions between two or more organizations, owned or controlled directly or indirectly by the same interests.

Optional Remedies

Advance pricing arrangements (APAs) and the Mutual Agreement Procedure (MAP) are available at the taxpayer's option. An APA is an agreement between the taxpayer and the BIR to determine in advance an appropriate set of criteria to ascertain the transfer prices of controlled transactions over a fixed period of time. On the other hand, MAP is a means under the tax treaties entered into by the Philippines with other tax jurisdictions through which tax administrations consult to resolve disputes regarding the application of double tax conventions. The BIR will issue separate guidelines on the application of APA and MAP processes.

Documentation

Adequate documentation must be maintained to enable the taxpayer to defend its transfer pricing analysis, prevent transfer pricing adjustments arising from tax examinations, and support its applications for MAP. While transfer pricing documentation is not required to be submitted when filing the tax return, it should be retained for the period provided under the Tax Code and submitted to the BIR when required or requested to do so.

Transfer pricing documentation should include, but is not limited to the following:

- Organizational structure;
- Nature of the business/industry and market conditions;
- Controlled transactions;
- Assumptions, strategies, policies;
- Cost contribution arrangements;
- Comparability, functional, and risk analyses;
- Selection of the transfer pricing method;
- Application of the transfer pricing method;
- Background documents; and
- Index to Documents.

Further, the documentation should be contemporaneous when it existed or is brought into existence at the time the related parties develop or implement any arrangement that might raise transfer pricing issues or review these arrangements when preparing tax returns.

Penalties for noncompliance with the transfer pricing regulations will be based on the provisions of the Tax Code and other applicable laws. Thus, failure to conduct a transfer pricing study may result in a compromise penalty under RMC 19-07. Moreover, in case a deficiency income tax assessment arising from a transfer pricing adjustment is assessed, the penalties under the Tax Code, such as the 25 percent (50 percent in case of fraud) surcharge and 20 percent interest per annum on the basic deficiency tax due will apply.

The regulations entered into effect on February 9, 15 days following publication in a general circulation newspaper.

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Korea Introduces New Rules on Cross-Border Financial Guarantees

The Korean Ministry of Strategy and Finance has issued guidance on the pricing of guarantee fees paid to Korean parent companies by its overseas affiliates. Effective January 1, 2013, Korean taxpayers must comply with new rules on the pricing of cross-border guarantees between related parties.

The ministry amended the Korean law governing transfer pricing, the Law on the Coordination of International Tax Affairs (LCITA), and added new clauses to Article 6-2 of the presidential decree of the LCITA (LCITA-PD), which provides guidance on intercompany services, and a new article to the ministerial decree of the LCITA (LCITA-MD).

The new clauses, Articles 6-2(3) and 6-2(4) of the LCITA-PD, specify the methods that may be used to calculate the arm's length price of a guarantee fee. The specific methods under Article 6-2(3) are as follows:

- A method based on the guarantor's expected risk and cost;
- A method based on the guarantee's expected benefit to the overseas affiliate; and
- A method based on both the guarantor's expected risk and cost and the guarantee's expected benefit.

Article 6-2(4) of the LCITA-PD provides two safe harbor rules whereby the following guarantee fees are deemed to be arm's length:

- Guarantee fees computed based on the difference between interest rates with and without a loan guarantee when the interest rate difference is calculated by the finance company providing the loan in question (the fee should be limited to the amount that can be confirmed through the interest calculation report prepared by the finance company making the loan); and
- Guarantee fees computed according to the conditions prescribed by the National Tax Service (NTS) commissioner as a method to calculate the arm's length price based on a guarantee's expected benefit.

The technical details of the NTS model have not been publicly disclosed. According to an NTS press release, the NTS examined the 2002 – 2007 financial data of all Korean corporations subject to external audit by law (corporations with a total asset size of KRW 7 billion or higher) and developed a standard credit ratings model. The NTS then determined the creditworthiness of both a guarantor and a guarantee based on past financial information dating back two years prior to the time the loan agreement was entered into. The difference between the respective risk premiums corresponding to the determined ratings is the arm's length price for a loan guarantee fee.

The new Article 2-3 of the LCITA-MD provides details on how to apply Articles 6-2(3) and 6-2(4).

Article 2-3(1) of the LCITA-MD specifies what elements a taxpayer should include to measure a guarantor's expected risk to apply the method under Article 6-2(3)1 of LCITA-PD. Article 2-3(1) specifies that the expected risk should be based on a guarantee's expected probability of default and expected probability of recovery.

Article 2-3(2) of LCITA-MD explains that the arm's length guarantee fee is the difference between the guarantee's cost of capital with a guarantee and the cost of capital without it when the method under Article 6-2(3)2 of LCITA-PD is applied. Article 2-3(2) specifies that the guarantee's expected benefit will be measured by the difference between loan interest rates or corporate bond interest rates with and without a guarantee on the basis of credit ratings of both the guarantor and the guarantee.

Article 2-3(3) of LCITA-MD provides a basis to construct a reasonable arm's length range on the basis of the expected risk and cost measured under Article 6-2(3)1 of LCITA-PD and the expected benefit measured under Article 6-2(3)2 of LCITA-PD.

Article 2-3(4) of LCITA-MD states that in applying Articles 2-3(1), 2-3(2), and 2-3(3), a credit rating, an expected probability of default, loan interest rates, and corporate bond interest rates should be calculated on the basis of reasonable data in light of availability, reliability, and comparability. Under this article, in particular, the following factors will be considered for a credit rating, an expected probability of default, and an expected probability of recovery: for a credit rating, in addition to past financial information, future financial information with a reasonable degree of predictability and nonfinancial information such as country risk, industry characteristics, the level of technology involved, market power/competitiveness, industry overall credit risks when both the guarantor and the guarantee operate will be considered. For an expected probability of default, factors such as a guarantee's credit rating and support from a group that the guarantee is a member of will be considered. For an expected probability of recovery information on a guarantee's financial status, size of tangible assets, industry characteristics, collateral, time that a loan is made, and maturity will be considered.

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Australia Introduces New Transfer Pricing Legislation into Parliament

A bill that includes amendments designed to modernize Australia's transfer pricing rules has been introduced into the Australian Parliament. While the transfer pricing aspects of the bill – the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 – replicate for the most part the Exposure Draft (ED) legislation released in late 2012, changes have been made that arguably water down some of the more controversial aspects of the ED. Moreover, it is disappointing that more of the concerns expressed during consultation on the ED have not been addressed.

The release of the bill came a day after the Organization for Economic Cooperation and Development (OECD) issued its report on base erosion and profit shifting (BEPS). The BEPS report highlights the need for actions to be implemented to curtail base erosion and profit shifting through practices that include transfer pricing. This provides an interesting backdrop for the evolution of Australia's transfer pricing rules, particularly given the government's decision to include reformed general anti-avoidance provisions and transfer pricing provisions in the same bill.

Currently, Australia's transfer pricing rules are comprised of three sets of provisions: Subdivision 815-A of the Income Tax Assessment Act (ITAA) 1997, the existing laws in Division 13 of the ITAA 1936, and the transfer pricing articles in Australia's double taxation treaties. The proposed changes to the transfer pricing rules would apply to income years commencing on or after the earlier of their date of enactment or 1 July 2013. The new laws would repeal Division 13, and Subdivision 815-A would not apply to income years to which the new laws apply. The new rules would apply both in treaty and nontreaty contexts.

The bill's main points of interest are summarized below.

Self-assessment – The proposed new operative provisions (Subdivisions 815-B and 815-C of the ITAA 1997) would be self-executing in their operation, unlike Division 13 and Subdivision 815-A, which apply through the making of a determination by the commissioner. Practically speaking, this means taxpayers must address compliance with the new provisions in lodging their income tax returns. Despite the fact that the new rules would operate on a self-assessment basis, taxpayers can only self-assess to increase taxable profits.

Time limit for amendments – Previously, there has been no limitation on the period during which the commissioner could amend an assessment to give effect to a transfer pricing adjustment. An eight-year amendment period was proposed in the ED, which has been reduced to seven years in the bill. There is no time limit on the commissioner's ability to ascertain additional amounts of withholding tax payable under Subdivision 815-B, or the commissioner's ability to make consequential adjustments.

Endorsement of OECD material – Proposed Subdivisions 815-B and 815-C must be applied "so as best to achieve consistency with" the OECD's transfer pricing guidelines and the model tax convention and its commentaries. In addition, some aspects of the OECD guidelines have been "unpacked" into the legislation itself (for instance, the most appropriate method rule and comparability factors for selecting and applying arm's length pricing methods). Thankfully, the wording in the ED specifying that OECD guidance did not need to be considered "where a contrary intention appeared" has been removed in the bill.

Reconstruction – The greatest concern expressed during consultation on the ED was the breadth of the proposed reconstruction power, given the commissioner's ability to substitute arm's length conditions and to look to the underlying economic substance of transactions. Helpfully, the Explanatory Memorandum (EM) to the bill states that the new provisions are intended to be applied by disregarding and/or reconstructing the actual transactions only in the "exceptional circumstances" prescribed in the OECD guidelines; however, the drafting of the provisions raises concerns as to whether the bill reflects that intention.

Documentation and penalties – In line with the ED, the bill states that failure to prepare the required transfer pricing documentation by the time the relevant tax return is lodged will mean that an entity cannot have a reasonably arguable position (RAP) for penalty purposes. The content and focus of transfer pricing documentation will be required to change to address the new rules, particularly in respect of substantiating arm's length conditions and aligning the actual conditions to arm's length conditions.

Broadening of the 'transfer pricing benefit' concept to withholding tax – The bill includes an additional, specific provision enabling the transfer pricing rules to be applied when a taxpayer has received a withholding tax benefit by virtue of non-arm's length conditions (for example, due to reduced interest or royalty payments).

Some other key aspects of the new rules, consistent with the ED, include:

Financing – There are specific provisions regarding the interaction of the thin capitalization and transfer pricing rules, so that a taxpayer with international related-party borrowings may be required to show that the amount of its debt is arm's length for purposes of pricing that debt.

Definition of arm's length conditions – The new rules allow for the substitution of arm's length conditions when an entity receives a transfer pricing benefit by virtue of non-arm's length conditions operating between it and its international related parties. The new rules therefore require "postulation of how independent entities in comparable circumstances would have dealt with one another had they been dealing at arm's length."

Profit attribution to permanent establishments (PEs) – Subdivision 815-C is intended to simply "modernize" the drafting of Division 13 as regards PE profit attribution while retaining the "relevant business activity" approach that involves an arm's length allocation of an entity's actual income and expenditure to its PE. The Board of Taxation is due to report to the government by the end of April 2013 as to whether Australia should adopt the authorized OECD approach (a "functionally separate entity" approach) for PE profit attribution, and we could see further reform in this area in the near future.

Conclusion

The new transfer pricing rules are designed to ensure that "the amount brought to tax in Australia from cross-border conditions that operate between entities reflects the arm's length contribution made by an entity's Australian operations." While the ATO contends that it is very much "business as usual" in terms of administering the transfer pricing provisions and the ATO's approach to cases, taxpayers must now do the work to apply the arm's length principle in determining taxable income before lodging their income tax returns.

Introduction of the bill in Parliament comes at a time when the Australian tax landscape for multinationals is changing rapidly. In addition to the proposed new transfer pricing rules, there is also a specialist reference group reviewing the taxation of multinationals, members of Parliament and the media are aggressively attacking multinationals' tax practices, and the Inspector General of Taxation is reviewing the ATO's management of transfer pricing matters. All of this is happening against the global backdrop of the OECD's work on base erosion and profit shifting, and a G20 that is increasingly interested in "fixing" an international corporate tax system that is seen as broken as a result of the world economy's recent evolution.

This environment is giving rise to significant challenges for dealing with transfer pricing issues, and it is more important than ever for taxpayers to ensure they are satisfied that their taxable incomes reflect arm's length conditions and that their cross-border arrangements are commercial.

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India Issues Two Transfer Pricing Circulars on Research and Development Activities

India's Central Board of Direct Taxes on March 26 issued two circulars, one providing clarification regarding the use of the profit split method for related-party transactions involving intangible property, and the other stipulating the requirements for a research and development center to be classified as a contract R&D unit.

Many multinationals carry out activities such as product development, analytical work, and software development through captive entities in India that exist in a wide range of fields, including IT software and hardware, pharmaceutical R&D, automobile R&D, and scientific R&D. The government of India recognized the need for clarity regarding the taxation of these entities, given that such development centers have made India a global hub for knowledge centers and provide significant employment opportunities.

Safe harbor provisions in this regard were introduced in Finance (No. 2) Act, 2009, but have yet to be made operational. In July 2012, the Prime Minister's Office constituted the Rangachary Committee to, among other things, suggest clarifications needed to remove ambiguity and improve clarity on the taxation of the IT sector and to finalize safe harbor rules sector by sector.

The Rangachary Committee submitted its recommendations to the government, and after considering the same, the CBDT issued Circular No. 01/2013 on 17 January 2013 on direct tax issues relating to exports of software. The CBDT has now issued two additional circulars, which seek to address transfer pricing issues pertaining to this sector:

- Circular No. 2 of 2013, providing clarification on the selection of the profit split method as the most appropriate method for pricing related-party transactions involving intangibles; and
- Circular No. 3 of 2013, which stipulates the conditions that must be cumulatively satisfied by a development center in India to demonstrate that it is a contract R&D service provider assuming insignificant risks.

Circular No.03/2013

Circular No. 3/2013 deals with the functional characterization of Indian development centers engaged in (R&D activities, and provides five tests, which must be cumulatively satisfied, to characterize R&D centers of foreign enterprises as contract R&D centers that assume insignificant risk.

The tests provided in the circular should be satisfied in substance, and not merely demonstrated through contractual arrangements. The five tests listed in the circular are outlined below:

- The foreign principal should perform most of the economically significant functions involved in the R&D cycle, while the Indian R&D center should be primarily involved in providing economically insignificant functions.
- The foreign principal should provide the necessary capital for the operations of the India R&D center. Further, all economically significant tangible/intangible assets required for the R&D activity should be provided by the foreign affiliate, and the Indian R&D center should neither employ nor have ownership of any economically significant tangible/intangible assets required for the R&D activity.
- The foreign principal should not only have the capability to control or supervise the activities of the India R&D center, but should actually exercise it. The activities of the India R&D center should be under direct supervision of the foreign principal, who should make strategic decisions to perform core functions as well as monitor the activities of the India R&D center on a regular basis.
- The India R&D center should not assume any economically significant risks. When the foreign principal is situated in a country that is perceived to be a low-tax/no tax jurisdiction, the tax authorities would presume that the foreign principal does not control the economically significant risks, unless the Indian R&D center demonstrates that the economically significant risks are indeed borne by the foreign principal.
- The legal and economic ownership of the research/intangible arising from the India R&D center should vest with the foreign principal.

Circular No.02/2013

CBDT Circular No. 02/2013 has been issued to clarify certain aspects that need to be kept in mind while selecting or rejecting the profit split method as the most appropriate method. The highlights of the circular include:

- Use of transfer pricing method which evaluates value of intangibles on a Cost plus Return basis, such as the transactional net margin method (TNMM), is discouraged, because there is no correlation between R&D cost and return on intangibles;
- The profit split method is the preferred method, because it determines an appropriate return on intangibles considering the relative contribution by each associated enterprise;

- Selection and application of the profit split method depends on factors prescribed under Rule 10C(2) of the Income Tax Rules, which include the nature and class of the transactions; functions, assets and risk analysis of the transacting parties; availability and reliability of data; degree of comparability with uncontrolled transactions; and the extent to which adjustments can be made to differences between controlled and uncontrolled transactions;
- If the Transfer Pricing Officer believes the profit split method cannot be applied due to the lack of reliable data, he must record reasons for the nonapplicability of the method before considering other methods;
- If the profit split method is not applied by the taxpayer because of the lack of information the taxpayer is required to maintain under section 92D read with Rule 10D, the taxpayer should have good and sufficient reason for the nonavailability of such information; and
- In an appropriate case, the TPO is empowered to consider the TNMM or the CUP as the most appropriate method to evaluate intangibles transactions and make upward adjustment taking into account the transfer of intangibles without additional consideration, location savings, and location specific advantages.

Comments

A combined reading of the two circulars reveals that the CBDT believes that if an R&D Center is not assuming significant risks and satisfies all conditions mentioned in Circular 3, then TNMM or the CUP method may be applied for determining the arm's length compensation for the Indian entity; otherwise, the PSM would be preferred.

Further, if any of the conditions in Circular 3 is not satisfied, it appears that it would be presumed that the intangibles are developed by the Indian R&D center, and Circular 02/2013 would apply.
Circular 03/2013 has left a number of issues open – ended, which could lead to further controversies. The circular provides that the foreign principal should perform most of the economically significant functions, provide economically significant assets, and assume economically significant risks. These principles are and have been the core for characterization of low-risk captive back office development centers. To bring certainty, it would have been useful if the CBDT had illustrated, through examples, what can be considered economically significant functions, assets, and risks.

The guidelines laid down by Circular No. 2 are intended to provide certainty on issues relating to application of the profit split method in transactions involving intangibles. To provider clarity the Circular should have explained, through examples, type of transactions that may be considered to be involving intangibles. This Circular has made PSM as the default method for transactions involving intangibles in so far as the TPO is required to record his reasons for not adopting PSM. Further, in cases when TNMM or CUP is used, the circular mandates that upward adjustment should be made to account for the value of the intangible transferred, location-specific advantages and savings. The manner of making such an adjustment and its quantification has not been provided, and is likely to be a challenging task – both for the Revenue and the taxpayer alike. The larger implication of this circular is that taxpayers engaged in intangibles transactions would have to take care of these principles while conducting their transfer pricing study.

Clearly, the objective of the circulars was to remove ambiguity in transfer pricing for MNCs that have development centers in India. Unfortunately, this objective may be far from being met, and uncertainty for MNC development centers could continue unabated.

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Dominican Republic Passes Tax Reform Amending Transfer Pricing Regime

The Dominican Republic's recently passed Law 253-12 on Tax Reform introduced significant changes to the country's transfer pricing regime. Due to these modifications, the provisions related to transfer pricing now apply to all entities operating in the country (regardless of the source of their capital) that enter into transactions with resident or nonresident related individuals, and with domiciled or nondomiciled related parties. The amendment implies that all enterprises or domiciled entities are subject to the transfer pricing regime, regardless of their source of capital.

The amendments also include the possibility of entering into advance pricing agreements (APAs) with the tax administration. Previously, APAs were available only for certain sectors, such as tourism (hotels), insurance, energy, and pharmaceutical companies.

The tax reform also introduced thin capitalization rules that limit the deduction due to interest payments on debts with or without related parties. The new law also establishes specific limitations for the deduction of expenses as a result of services among entities of the same economic group (corporate expense deductions) considering whether they are in accordance or not with market values.

Below are some specific details of the most relevant changes.

Scope of the transfer pricing regime

All local companies (regardless of the source of their capital) and permanent establishments of foreign companies that perform operations with related entities or individuals (domiciled and nondomiciled; resident or nonresident) are subject to the transfer pricing obligations. Thus, the entities that fall within the scope of the law must file with the tax authorities an annual Informative Return of Operations with Related Parties during the fiscal year ("DIOR," for its Spanish acronym), and must perform a transfer pricing analysis of their transactions with related parties during the fiscal year. Before the tax reform was passed, these rules applied only to transactions with nondomiciled and nonresident related parties.

Related parties

The terms under which two or more parties are considered to be related are set forth in the new (amended) article 281 of the Dominican Tax Code (DTC), as follows:

- One of the parties, individuals, legal entities participates directly or indirectly in the management, control, or capital of the other.
- Legal entities with a permanent establishment abroad, or when they are part of an economic group, or when one of the parties is domiciled in a tax haven or a jurisdiction with a privileged tax system.
- Companies with exclusivity agreements or those that transfer to each other more than the 50 percent of their production, or an entity that takes care of the losses and expenses of the other.
- When entities have a common decision-making unit.

Modification of the Methods

The available transfer pricing methods to analyze transactions are reduced to five:

- Transaction-based methods, which have priority in choosing the most appropriate method:
  - The comparable uncontrolled price method;
  - The resale price method; and
  - The cost plus method.
- Profit-based methods, which may be applied when the lack of available information precludes the application of the transaction-based methods:
  - The profit split method; and
  - The transactional net margin method.

The transfer pricing analysis must contain at least a description of the business and the responsibilities of the tested party, including the corresponding assets and the risks assumed; a description of the contract terms of the operations, the economic or market circumstances, and the business strategy.

The analysis must also include information about the environment value and about the tested party. Also, the identification, availability and veracity of the transfer pricing analysis of comparable operations, selection of the most appropriate method, and analysis of comparability and adjustment performance, if applicable.

APAs

Without exception, all taxpayers may request to enter into an APA with the tax authorities. This agreement would be applicable for the year in which the request is made and for the three subsequent fiscal years. In the case of APAs application for previous periods, the limit will be two years. The procedure to apply for an APA includes a taxpayer's proposal, which can be modified by the tax authorities; these amendments do not necessarily have to be accepted by the taxpayer.

Services between related parties

For services between related parties, expenses will be deductible as long as the taxpayer is in a position to prove that:

1. The service has been effectively rendered;
2. The service provides the recipient an economic or commercial benefit; and
3. The value or amount agreed to is consistent with the value or amount that would have been agreed by independent parties.

If the previous conditions are not met, the expenses could be considered nondeductible by the tax administration.

Use of Conduit Companies

The Tax Reform contemplates the evaluation of export operations when there is an unrelated intermediary that is not the effective recipient of the merchandise. Under this structure, the intermediary could be considered a related entity by the tax administration, and the operations carried out through this legal organization should be adjusted according to the market prices.

Penalties

Failure to comply with the transfer pricing documentation provisions is considered a violation of the taxpayer´s formal duties, and economic sanctions could be applied up to three times the tax base as set forth in article 267 of DTC:

- From five to 30 minimum salaries; and
- Fines up to 2.25 percent of the previous year's taxable income.

In addition to the penalties for noncompliance with the documentation obligations, if a transfer pricing adjustment is also determined, the penalties of article 25 of the DTC could be applied: up to twice the amount of the omitted tax, or if the fine can't be determined; the amount will be fixed between 10 and 50 minimum wages.

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Italian Court Rules on Nondeductible Interest Expense for Undercapitalized Branches

Italian branches of a foreign bank must have a capital structure adequate to their activities and risks, equivalent to the capital structure that an autonomous and independent bank would have for "regulatory" purposes, according to the Regional Tax Court of Milan. Therefore, an adequate amount of equity capital should be attributed to an Italian branch for tax purposes, regardless of the actual capital amount shown on the branch's books, and the branch's liabilities and deductible interest expense should be adjusted accordingly.

This is, briefly, the principle stated by the Regional Tax Court of Milan (an appellate court) in judgment No. 62 published on June 12, 2012.

The Tax Dispute

The decision of the Regional Tax Court of Milan concerned two notices of tax assessment for fiscal periods 2003 and 2004 issued to the Italian branch of an English bank. The Tax Office challenged an undue deduction of (i) interest expense on financial loans paid to the head office; and (ii) losses on bad debts attributable to the banking activities performed by the head office, and not part of the branch's activity.

Regarding the interest expense issue, the Tax Office argued that part of the funding lent by the head office to the branch had to be reclassified as "free capital" by virtue of the fact that the branch was not allocated any equity for tax purposes.

The Tax Office's arguments were substantially based on provisions set forth in article 7, paragraph 2, of the double tax treaty between Italy and the UK that, consistent with the OECD model tax convention, establishes both the arm's length principle and the "separate-entity approach" in assessing profits attributable to a permanent establishment (PE). Under those provisions, those profits shall be those the PE would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under similar conditions. Specifically, the Tax Office made reference to paragraph 18.3 of the OECD Commentary to article 7 (in the version existing at the time of the tax assessment) which provides that a PE should have "… a capital structure appropriate to both the organization and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally…"

Therefore, the Tax Office stated that an Italian branch of a foreign bank must have "free capital,"[2] even if "notional" for tax purposes, at least equal to the capital amount required under domestic regulatory provisions for independent banks incorporated under the laws of Italy. In this respect, the regulatory capital defined pursuant to Circular Letter of Bank of Italy no. 229/1999 (6.3 million of euros) was considered the amount of funding necessary to qualify as "free capital" of the Italian PE.

According to the Milan Tax Office, the allocation of "free capital" is a necessary adjustment to guarantee that the arm's length principle is respected, by virtue of the principles set forth in the aforementioned article 7; otherwise, Italian branches of foreign banks would benefit from a competitive advantage compared with independent banks incorporated under the laws of Italy.

Consequently, by allocating adequate capital to the branch, part of the branch's debt will be requalified as non-interest-bearing capital, while only arm's length interest on debt exceeding that amount may be deducted for tax purposes.

The taxpayer's defense strategy was substantially based on the lack of a legal basis justifying the tax assessments. More specifically, the Italian branch argued that (i) no Italian tax or regulatory provisions obligate a branch of a foreign bank to have a minimum "free capital," (ii) no tax provision establishes criteria to be used to allocate profits to a branch, and (iii) the provisions under double tax treaties are established to avoid double taxation issues, not to create new theories of taxation not contemplated under domestic tax law.

The Provincial Tax Court of Milan (the trial court) issued decision no. 117/01/2010 of February 1, 2010, in favor of the taxpayer, and the Tax Office appealed the decision before the Regional Tax Court.

The Regional Tax Court's Decision

The Regional Tax Court's judges, overturning the decision of the Provincial Tax Court, confirmed the validity of the tax assessments.

First, the judges stated that the right of the host state to levy taxes on foreign enterprises' permanent establishments (located within its territory) implies that the state should pay attention to verify whether the actual debt/equity ratio of the branch is appropriate. A shortage in the equity considering the activity performed and the risks borne by the branch may, in fact, indicate excessive "indebtedness" of the branch toward its head office, thus creating an improper allocation of income (through the payment of interest on deemed financial loans) in the state of the head office.

The court then clarified that the claim under discussion was not related to the existence or not of a provision requesting an endowment fund for branches (such as the regulatory provisions for Italian banks), but how interest expenses should be

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[2] Funding that does not give rise to a tax deductible return in the nature of interest.

treated from a tax perspective when it is ascertained that the branch's banking activity is performed (in part) thanks to the head office's funding.

In this respect, the court stated that "similar to independent companies, an Italian PE of a foreign enterprise must have free capital that, only for tax purposes, could be also notional. In other words, in case the free capital does not result from the branch's balance sheet, it should then be determined only for tax purposes in order to assess if the deducted interest expenses have been duly determined so as they would be by an independent company."

Moreover, according to the court, "the free capital from a tax perspective is adequate if it meets the regulatory thresholds provided for Italian banks," thus equal to 6.3 million of euros in the case at hand.

The court concluded by affirming the correctness of the reference made by the Tax Office to the arm's length principle under both article 7, paragraph 2, of the Italy-UK double tax treaty and article 110, paragraph 7, of the Italian consolidated Tax Code. In fact, the court said, the proper application of the arm's length principle will keep undercapitalized permanent establishments from benefitting from treatment that may harm not only the Italian state but also other Italian banking institutions, which would suffer from unfair competition.

Preliminary Remarks

The judgment of the Regional Tax Court of Milan represents confirmation of a trend previously expressed both by the Tax Agency (Resolution 30 March 2006, no. 44) and by tax courts (Provincial tax court of Milan, decision 1 December 2010, no. 475), in similar cases.

The decision highlights the fact that Italian tax courts (and tax authorities) are increasingly relying on international practice and tax principles developed at the OECD level when addressing international tax matters under Italian law. Indeed, the decision is substantially compliant with one of the approaches followed by the OECD to determine a branch's "free capital", the "quasi-thin capitalization" approach (also called the safe harbor approach) mentioned in the Report on the Attribution of Profits to Permanent Establishments, which requires a branch to be allocated/attributed at least the same amount of "free capital" as would be required for regulatory purposes from an independent banking enterprise operating in the host country.

This case law trend should push foreign banking enterprises willing to do business in Italy to carefully evaluate the adequacy, from a tax perspective, of the "free capital" allocated/attributed to their branches; such an evaluation would of course require a case-by-case analysis of all facts and circumstances, taking into account and valuing assets (tangible and intangible) used, the functions performed, and the risks undertaken by the branch.

That adequacy should be also documented in the Italian "Country File" of a branch, to comply with the penalty protection requirements set forth to avoid the application of administrative penalties (ranging from 100 percent to 200 percent of taxes due) in case interest payable is challenged based on a free capital adjustment.

Moreover, we believe that advance pricing agreements (APAs) (the "Ruling Internazionale") may represent an important tool for Italian branches of foreign taxpayers to obtain certainty in advance on the tax treatment of their business transactions connected with the Italian territory.

Finally, it should be noted that the decision discusses the approach for determining the branch's deductible interest expense not only with reference to the banking business but in general terms. Therefore, all industries should be potentially interested.

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Peru Issues Guidance on Transfer Pricing Documentation Requirements

Peru's tax authorities launched on 21 February 2013 an open consultation on a draft resolution to clarify the scope of recently enacted rules concerning transfer pricing documentation requirements. The documentation rules entered into effect on 30 June 2012 under Legislative Decree No. 1112. The draft guidance now being discussed by the tax authorities could impact reporting obligations for fiscal year 2012, which are due in 2013.

Traditional Formal Requirements

Under the income tax provisions, Peruvian taxpayers must file an annual transfer pricing informative return that includes transactions entered into with related parties and with companies resident in tax havens. In addition, Peruvian taxpayers must keep a technical transfer pricing study supporting in detail the methodology and criteria used. The form, terms, and conditions for the reporting are set forth by the tax authorities.

In line with the ability granted to the tax authorities by the income tax law, guidelines containing safe harbors for the transfer pricing formal documentation requirements were issued under Resolution No. 167-2006-SUNAT, as follows:

- Peruvian taxpayers must file an annual transfer pricing informative tax return during the subsequent fiscal year (that is, the second and third week of June, depending on the taxpayer's ID) when (a) the amount of transactions with related parties during the fiscal year exceeds PEN 200,000, and/or (b) if they have conducted at least one transaction from, to, or through a tax haven.
- Peruvian taxpayers must have a technical transfer pricing study when (a) their accrued income exceeds PEN 6,000,000 and the amount of transactions with related parties exceeds PEN 1,000,000, and/or (b) if they have performed at least one transaction from, to or through a tax haven.

The tax authorities are entitled to request this study at any time after closing the applicable taxable year. In practice, it is only required once a tax audit procedure has been initiated.

Legislative Decree No. 1112

Legislative Decree No. 1112 amended the income tax law to provide that the transfer pricing documentation requirements apply only to transactions deriving taxable income and/or allowable deductions (tax basis or expenses). In addition, it grants power to the tax authorities to enforce the transfer pricing documentation requirements.

Pursuant to the authority granted, and with the goal to conform the traditional formal requirements to the amendments introduced by Legislative Decree No. 1112, the draft resolution limits the circumstances under which the obligation to submit a transfer pricing informative return and/or a technical transfer pricing study will apply:

- For purposes of applying the safe harbor rules, "the amount of transactions" will comprise the sum of the figures agreed to in transactions with related parties and with residents in tax havens for the following concepts: (a) taxable income accrued during the fiscal year; (b) acquisitions or goods and/or services that qualify as allowable deductions for income tax, or those that even when nondeductible qualify as taxable income for one of the parties involved.
- Peruvian taxpayers must file an annual transfer pricing informative return when "the amount of transactions" entered into during the fiscal year exceeds PEN 200,000, using electronic form No. 3560.
- Peruvian taxpayers must have a technical transfer pricing study when (a) their accrued income exceeds PEN 6,000,000 and "the amount of transactions" exceeds PEN 1,000,000. This study must be submitted to the tax authorities in PDF form as an appendix to electronic form No. 3560.

Once approved, the proposed resolution will be published in the official gazette and will enter into force the following day. It is likely that enactment will take place before the due date for submitting the 2012 informative return.

Comments

Taxpayers must submit the transfer pricing informative return corresponding to fiscal year 2012 during the due dates approved for obligations corresponding to the period May 2013 (from 10 to 24 June 2013, depending on the last number of the taxpayer's ID).

In this context, if the draft resolution is approved before June 2013, the technical transfer pricing study corresponding to 2012 would be required as an appendix to the electronic return. This would be the first year in which the technical transfer pricing study is subject to a filing deadline, and it is not clear whether the tax authorities will provide an extension.

Potentially affected taxpayers should begin to assess the impact of the new transfer pricing documentation requirements now to ensure compliance.

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