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OECD Releases Draft Handbook on Transfer Pricing Risk Assessment

The Organization for Economic Cooperation and Development has published a new draft handbook on transfer pricing risk assessment, intended to be a detailed, practical resource for countries to follow in developing their own risk assessment approaches.

The objective of the draft handbook is to support tax authorities in their allocation of limited resources by providing effective means to select cases that should be subject to a resource-intensive transfer pricing audit – those that are "high risk" from a particular tax authority's viewpoint and therefore warrant the commitment of resources. The draft handbook emphasizes that to select appropriate cases the processes of risk identification and assessment must be effective, but that done correctly the assessment has the potential additional benefit of allowing the actual audit to be more focused, shorter, and more effective.

The draft handbook recognizes the challenges facing tax authorities in assessing transfer pricing risk, and considers several key questions for tax authorities establishing risk assessment processes:

- What questions should be asked and answered in assessing transfer pricing risk?
- What is the level of certainty required in assessing transfer pricing risk?
- What are the risk factors affecting transfer pricing?
- What sources of information are available for conducting a transfer pricing risk assessment?
- How does the risk assessment process influence the selection of cases for audit?

The draft handbook also includes a section on building relationships with taxpayers under the "enhanced engagement" approach, using examples of transfer pricing risk assessment approaches and cooperative compliance adopted by the Netherlands (the Horizontal Monitoring program), the UK (Real Time Working initiatives) and the United States (the Compliance Assurance Program).

The draft handbook is intended to be practical in nature – designed for use by tax authorities in developing or improving procedures, methods, and practices that fit within their own domestic legal and tax audit frameworks. As such, there is no prescribed "one size fits all" approach. The OECD is keen to emphasize that the draft handbook should be a manual for use by both developed and developing countries, that a highly sophisticated risk assessment system may not be suitable for all tax administrations. Moreover, the level of sophistication should be related to resources available to manage risk

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assessment, the size of the pool of taxpayers engaging in cross-border transactions with related parties, the exposure of the jurisdiction to transfer pricing risk, and the stage of the tax administration's development in transfer pricing enforcement.

The handbook also emphasizes the importance of using the risk assessment process to design a coherent and practical plan for any subsequent auditing of specific transactions, again with a view to providing the best use of resources, and should identify specific questions that must be considered during the audit.

In assessing risk factors, the handbook looks at three key areas of taxpayer's affairs:

- Types of transactions – including recurring, high-volume transactions and large or complex one-time transactions;
- Taxpayer behavior in terms of governance, tax strategies and compliance capabilities; and
- The amount of tax potentially at risk.

These areas are considered in light of evaluation factors such as profitability in comparison with industry standards or potentially comparable companies, profitability in comparison to group results, recurring losses or low returns on investment, fluctuations contrary to market trends, and/or substantial income in low-tax jurisdictions.

Effective risk assessment procedures are beneficial to both tax authorities and taxpayers – it is in nobody's interest to have lengthy and costly transfer pricing audits that end with no material adjustments, or in which any adjustment is subsequently overturned in a mutual agreement procedure under a double tax treaty. Thus, the draft handbook, which is detailed in its approach and practical in its observations, is a welcome addition to the OECD's guidance for tax administrations in relation to transfer pricing.

The OECD has invited interested parties to submit comments on the draft handbook by 13 September 2013.

— Alison Lobb (London)
Director, International Tax
Deloitte United Kingdom
alobb@deloitte.co.uk

OECD's Draft Handbook on Transfer Pricing Risk Assessment Examined from Canadian Perspective

The Organization for Economic Cooperation and Development (OECD) on May 31 released the *Draft Handbook on Transfer Pricing Risk Assessment* for public consultation. The objective of the draft handbook is to provide a practical resource tax administrations can use to assess transfer pricing risk for an individual taxpayer in their respective jurisdictions. This draft publication is the latest effort by the OECD to address the need to efficiently employ the limited resources available to audit transactions between entities under common control that conduct business in different tax jurisdictions.

The need for efficient deployment of resources has never been stronger, given the increasingly complex and globalized nature of the modern economy, coupled with government spending cuts in some countries in response to global economic woes. Being able to select appropriate audit targets is critical to minimize wasted resources, both for tax administrations and for taxpayers subject to audits, which frequently span multiple years and involve hundreds of hours of cumulative effort.

The Canada Revenue Agency (CRA) in recent years has updated its method of selecting taxpayers with international transactions for audit. For example, the CRA has abandoned its former approach of assigning audits based on taxpayers' gross income; instead, it now utilizes a risk-based audit selection method. Considering the CRA has moved toward a risk-based approach when selecting taxpayers to audit, as well as the fact that Canada is a contributing member in drafting OECD guidance, it appears that the CRA is already considering at least some of the OECD's guidance included in the draft handbook in the CRA's audit selection process.

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OECD's Draft Handbook on Transfer Pricing Risk Assessment

The draft handbook is meant to aid tax administrators by proposing activities that should be performed *before* the decision is made to undertake a serious commitment of resources investigating taxpayer's primary sources. Taxpayers can also use this guidance to evaluate their own transfer pricing risk profile.

The most relevant information in the draft handbook for taxpayers is its identification of risk factors, which under the OECD guidance should be used to evaluate higher-risk fact patterns and ultimately which taxpayers should be selected for a formal transfer pricing audit. Some of the key risk factors identified in the draft handbook are included in the table below.

Summary of Risk Factors Highlighted in the Draft Handbook	
Broad Risk Factor Category	Risk Factor Examples
Base eroding payments	Examples include royalties, rental payments, management fees and charges for other related-party services, financial instruments including loans and deductible interest thereon, financial derivative contracts and insurance, as well as other large recurring transactions, including large-volume sales or purchases of products or services.
Tax attributes of related nonresident parties	Examples include material transactions with related entities in low-tax jurisdictions, as well as material transactions with related entities with tax or withholding rules that make them useful as a conduit to low-tax jurisdictions.
Large one-time transactions	The transactions in this category include in particular those that have the potential to impact the transfer pricing relationships between group members in future years, such as business restructurings, transfers of important income producing assets (especially transactions involving intangibles), and cost contribution arrangements.
Profitability anomalies	In comparison to industry standards and comparable companies or in comparison to related parties, as well as persistent operating losses over a period of years or fluctuations that are contrary to market trends.

The draft handbook also identifies risk factors that are entirely independent of the transactions themselves, such as compliance effort by the taxpayer, history of noncompliance, and other factors. Having sufficient information regarding the transactions, and cooperating with tax administrations when requests are made (such as providing sufficient transfer pricing documentation on a contemporaneous basis when requested) are controllable factors that may influence a tax administration's risk assessment of a taxpayer.

Conversely, the draft handbook identifies indicators of low transfer pricing risk, such as low volume of controlled transactions, the presence of comparable uncontrolled transactions that are used to establish the transfer price, transactions with entities in jurisdictions with relatively higher marginal tax rates, and the presence of minority shareholders whose interests would be influenced by the division of profit between the related parties.

In conjunction with the above risk factors, the draft handbook suggests a quantitative evaluation of the amount of potential amount of taxable income at stake, including consideration of whether there is systemic risk, such that even low-value transactions may deserve additional scrutiny if they involve a large volume of taxpayers.

To gather information to identify and assess the above risk factors, the draft handbook suggests sources for tax administrations to obtain, including supplemental information return forms that disclose information relevant to transfer pricing arrangements not ordinarily included in a tax return. The draft handbook makes recommendations in respect of what information tax administrations should require in information return forms, including:

1. Identification of related-party transactions;
2. Identification of related parties with which controlled transactions are carried out;
3. Nature and amount of controlled transactions carried out with each related party;
4. Segmented financial results of each controlled transaction; and
5. Description of the differences between a taxpayer's financial statement and its income tax return income (i.e., book/tax differences).

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Many tax administrations have such information return forms in place, such as Canada's Form T106: Information return of non-arm's length transactions with nonresidents, and others in India, Norway, and the United States are mentioned in an annex to the draft handbook, though the breadth and depth of information required varies by jurisdiction.

It is interesting to note the inclusion of segmented financial results of each controlled transaction in the OECD's suggested information return demands, as this is in practice not often separately tracked by taxpayers, and performing such segmentation generally requires material assumptions to allocate certain entity-wide costs to one particular transaction.

The final section of the draft handbook describes building relationships with taxpayers to the mutual benefit of the tax administration and the taxpayer. The draft handbook suggests that a sensible discussion between the taxpayer and tax administration about transfer pricing before a tax return is filed, or even before a transaction takes place, could lead to opportunities for taxpayers and tax administrations to consider issues and get comfortable with transfer pricing positions at an early point in time – with the objective of reducing the magnitude of future detailed transfer pricing examinations.

Potential impact to Canadian taxpayers

The CRA has already shown interest in moving toward a risk-based audit selection approach, for example by utilizing the details included in Form T106s to screen taxpayers for audit for a number of years, and more recently by focusing on enhancing CRA audits as mentioned in Technical News Letter No. 34, dated April 27, 2006 – the CRA has been investing significant resources "to increase audit and compliance capacity with respect to cross-border and international transactions using a risk-based approach and investing in research and analytical capability." Further, consistent with the draft handbook's suggestion to build relationships with taxpayers, the CRA has been conducting risk assessment interviews with some of Canada's largest businesses.

While in practice the CRA may have already been considering several of the risk factors identified in the draft handbook in the past, the CRA generally does not publicize its risk assessment process. Given that the CRA has moved to adopt a risk-based approach to audit selection, and as Canada is a contributing member involved in the drafting of OECD publications, the draft handbook is a useful resource in that it provides significant detail regarding what the CRA may consider when performing a risk assessment and filtering transfer pricing audit candidates.

The draft handbook therefore provides Canadian taxpayers (as well as taxpayers in other jurisdictions that follow OECD guidelines) a useful glimpse at what may be considered by tax administrators when evaluating transfer pricing risk and selecting audit candidates. By understanding the risks identified in the draft handbook, taxpayers can prepare themselves by thoroughly documenting transfer pricing transactions – particularly those identified in the draft handbook's risk factors.

The Handbook on Transfer Pricing Risk Assessment is still in draft form and has not been finalized; the OECD Steering committee is inviting interested parties to provide comments by September 13, 2013.

— Muris Dujsic (Toronto)
Partner
Deloitte Canada
mdujsic@deloitte.ca

Simon Gurr (London)
Senior Manager
Deloitte Canada
sigurr@deloitte.ca

Alex Evans (Burlington)
Senior Analyst
Deloitte Canada
alevans@deloitte.ca

Italy Releases Second Report on APA Program

The International Ruling Office of the Italian Tax Agency on March 19 released the second edition of its International Ruling Report, which provides detailed statistics on the applications filed with the office following the introduction of the International Standard Ruling in 2003. The report covers the office's operations during the entire period since the inception of the APA program, with a focus on the last three years.

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The International Ruling in theory may be used in to reach agreement on a variety of international tax matters, including:

- The correct transfer pricing methodology applicable to transactions carried out with related parties;
- The tax treatment provided for by law, including tax treaties, to dividends, interest, royalties, or other income paid to or received from nonresident persons in specific cases;
- The application of the provisions of the law, including tax treaties, to specific cases related to the attribution of profits or losses to permanent establishments in Italy of non-resident enterprises as well as to permanent establishments abroad of resident enterprises.

In practice, however, this administrative tool is primarily used to negotiate advance pricing agreements (APAs); only one case out of a total of 56 involved an issue other than transfer pricing.

The report discusses the transfer pricing methods utilized in the APAs concluded during the period in question, and states that profit-based methods, mostly the transactional net margin method (TNMM), were applied in 79 percent of cases, whereas traditional transactional methods were applied in the remaining 21 percent of cases.

With regard to the type of transactions subject to the rulings, most cases dealt with manufacturing, distribution, or provision of intercompany services, with a minority of cases dealing with royalties (five cases), cost sharing agreements (two cases), and the attribution of profit to permanent establishment (4 cases).

The report highlights a steady trend toward a progressive increase in the number of applications filed annually, from just 2 in 2005 (although the "International Ruling" was implemented 2004, it could not be activated in practice until it obtained approval from the EU Commission, February 2005), to 38 in 2012 (for a total of 135 filings in 2004-2012). The efficiency of the Rulings Office has also improved, considering that, in spite of the increase in the number of applications, the average length of an APA negotiation dropped from 20 to 16 months (15 months if only APAs signed in the three-year period of 2010-2012 were considered).

Italian APAs, once signed, are valid for a period of three fiscal years, starting in the year in which the signing took place, with no rollbacks, and are renewable for subsequent periods of three fiscal years through a simplified procedure, provided the legal and economic conditions under which they were negotiated did not change significantly.

Access to the international standard ruling procedure occurs on a voluntary basis and, unlike other countries, Italy does not require payment of a filing fee. According to the law, only "enterprises with international business" are eligible for accessing the procedure. As regards APAs, such enterprises include:

- Resident entities that have commercial relationships with foreign related parties (i.e., part of the same group of companies);
- Nonresident entities that carry on business in Italy through a permanent establishment, that qualifies as such under the relevant provisions of the Italian Consolidated Income Tax Code.

Broadly speaking, the international standard ruling is part of the tax compliance policy, which aims to improve cooperation and dialogue between taxpayers and the tax administration. Moreover, it provides legal certainty to both taxpayers and the tax administration, preventing legal disputes and reducing the risk of international double taxation.

In addition to general and statistical information, the new report confirms two important developments in the ruling procedure and in the Italian APA program:

- Introduction of a prefiling phase; and
- The possibility of negotiating bilateral or multilateral APAs, in addition to unilateral APAs.

Prefiling

For the first time, the tax authorities confirmed that taxpayers will have the option to avail themselves of a prefiling meeting, allowing them to explore the possibility/opportunity of filing an APA application before actually committing to it.

Prefiling conferences consist of one or more meetings between the Ruling Office and the taxpayer or its representatives prior to the filing of a ruling application, giving the Ruling Office the opportunity to illustrate the general aspects of the

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procedure and taxpayers the main features of their cases and to obtain preliminary feedback from the office. Prefiling conferences may be either on a no-name or on a disclosed name basis.

The report shows a progressive increase in the number of prefiling conferences on a disclosed-name basis over no-name ones, a sign of growing trust among businesses in the fairness and reliability of the Italian International Ruling Office.

Bilateral or Multilateral APAs

Perhaps more significant is the confirmation that, notwithstanding the fact that the specific legislation regulating international rulings provides only for unilateral rulings, the Italian tax authorities started in 2010 to offer taxpayers the possibility of entering into bilateral or multilateral APAs, based on the articles of relevant Italian bilateral tax treaties corresponding to article 25, paragraph 3 of the OECD Model Treaty.

As of December 31, 2012, 19 bilateral APAs were being negotiated with European Union countries (in particular, France, Germany, The Netherlands, UK, Spain, Sweden) as well as with non-EU countries (in particular, U.S.A., Japan and Switzerland).

— Aldo Castoldi (Milan)
Partner
Deloitte Italy
acastoldi@sts.deloitte.it

Marco Mazzetti (Rome)
Director
Deloitte Italy
mmazetti@sts.deloitte.it

Peru Issues Guidance on Transfer Pricing Documentation Requirements

The Peruvian tax authorities have issued a resolution to provide guidance regarding the formal transfer pricing reporting requirements, and to extend the deadline for complying with the 2012 transfer pricing requirements.

Resolution No. 175-2013-SUNAT, published in the official gazette on 30 May 2013, provides guidelines containing safe harbors for the transfer pricing formal documentation requirements originally regulated by Resolution No. 167-2006-SUNAT. The new resolution entered into force the following day, and it amends the content of the former guidelines to conform to the scope of rules on transfer pricing formal documentation requirements that came into effect on 30 June 2012 pursuant to Legislative Decree No. 1112. The new guidelines affect the 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 regarding transactions entered into with related parties and with companies resident in tax havens. Moreover, 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 accordance with the ability granted by the income tax law, the tax authorities provided guidelines containing safe harbors for the transfer pricing formal documentation requirements with the issuance of Resolution No. 167-2006-SUNAT, which provided that:

- 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 total amount of transactions with related parties during the fiscal year exceeds PEN 200,000; and/or (b) if they have entered into 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 entered into at least one transaction from, to, or through a tax haven.

The tax authorities were entitled to request this study at any time after the closing of the applicable taxable year. In practice, it was requested only when a tax audit procedure was initiated.

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Legislative Decree No. 1112

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

Pursuant to the authority granted, and in an effort to reconcile the traditional formal requirements to the amendments introduced by Legislative Decree No. 1112, the new resolution delineates the circumstances whereby 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 from, to, or through tax havens, for the following concepts:
  - Taxable income accrued during the fiscal year;
  - Acquisitions of goods and/or services and other types of transactions concluded in the fiscal year that provide tax basis or qualify as an allowable deduction for income tax, or those that even when nondeductible qualify as taxable Peruvian-source income for one of the parties involved. Transfers of property for no consideration should be considered at their tax basis value.
- Resident taxpayers must file an annual transfer pricing informative return using electronic form No. 3560 when "the amount of transactions" during the fiscal year exceeds PEN 200,000, or if they have sold goods to related parties or from/to or through tax havens, provided their tax basis exceeds their market value.
- Resident taxpayers must have a technical transfer pricing study when their accrued income exceeds PEN 6,000,000 and "the amount of transactions" exceeds PEN 1,000,000; and/or if they have sold goods to related parties from/to or through tax havens, provided their tax basis exceeds their market value. This study must be submitted to the tax authorities in PDF form as an appendix to electronic form No. 3560.

Electronic form No. 3560

The resolution approved version 1.3 of electronic form No. 3560, which can be downloaded from the tax authorities' website from 1 June 2013.

The use of version 1.2 of electronic form No. 3560 is allowed only until 31 May 2013. Thus, after that day, even amended transfer pricing informative returns concerning previous taxable years would need to be submitted using the upgraded version.

Due dates for the 2012 reporting obligations

The resolution also provides that, as an exception, the filing deadline for the 2012 transfer pricing informative tax return, which taxpayers were originally required to submit by June 2013, will now be the applicable due date for period September 2013 tax obligations; that is, the second and third week of October 2013, depending on the taxpayer's ID number.

Comments

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

However, in line with the guidelines provided by the resolution, for the first time the 2012 technical transfer pricing study will be included in the report as an appendix. To allow taxpayers time to comply with this obligation, the reporting deadline has been extended until October 2013.

Potentially affected taxpayers should begin to assess the impact of the new transfer pricing formal documentation requirements to ensure appropriate compliance within the remaining four months before the beginning of the reporting dates.

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— Gustavo Lopez-Ameri (Lima)
Partner
Deloitte Peru
glopezameri@deloitte.com

Ana Luz Bandini (New York)
Senior Manager
Deloitte Tax LLP
anbandini@deloitte.com

Indonesia Issues New Regulation on Transfer Pricing Audits

Indonesia's Directorate General of Taxation (DGT) on May 30 promulgated Regulation PER 22/PJ/2013, which provides guidelines for audits of taxpayers with related-party relationships. The regulation will be effective from 1 July 2013, and will also be applicable to ongoing tax audits, that is, audits that were initiated prior to the issuance of this regulation but have not been completed. PER 22 revokes KEP-01/PJ 07/1993, which provided guidelines for audits of taxpayers with related-party relationships.

The salient features of the regulation are described below.

Application of three different principles

The regulation requires the application of three different standards that may yield different results – the principle of "fairness", "common business practice," and the arm's length principle. Furthermore, reaffirming the intent of Article 18 (3) of the Income Tax Law, the regulation authorizes the DGT to test the application of the arm's length principle and to redetermine the amount of income and deductions in accordance with "fairness" and "common business practices" not influenced by special relationships.

Industry standard as "common business practice"

The regulations encourage comparing taxpayers' results with industry comparables using average financial ratios as part of a preliminary examination. Aside from the financial ratios ordinarily used, the regulations allow the use of the Berry ratio, R&D expenses to sales and marketing expenses to sales and debt to equity ratios.

Characterizing the taxpayer

The regulation reiterates the different characterizations for manufacturing and distribution setups. Manufacturing entities may be characterized as full-fledged, contract, or toll manufacturers, and distributing companies may be characterized as full-fledged distributors, limited-risk distributors, and commissionaires and commission agents. Taxpayers are required to disclose this characterization in a special form within seven days from receipt of the request letter. Extreme caution should be exercised in completing this form, as it will bind the taxpayer during the audit.

Authorized databases

The regulations require the use of public data (either foreign or domestic) from commercial databases, such as the London Metal Exchange and other databases as sources of external comparables.

Introduction of two tested parties

The DGT has provided that the tax auditors may select two tested parties in testing the arm's length nature of intercompany transactions. While there is no detailed guidance on this issue, introducing such a requirement in the regulation may lead to testing of the foreign related party. Furthermore, when a part of the supply chain is performed by a foreign party, the net operating profit of the foreign party is also required to be submitted within seven days from the date of the request.

How many years should be tested?

The regulations now require the use of multiple-year data on both the tested party and the independent comparables. However, the regulation is silent on the number of years of financial data to be used for undertaking such multiple-year analysis.

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Use of "deemed transactions" to justify "secondary adjustments"

The DGT in PER-22 formalizes its practice of constructing a deemed transaction to justify imposing an additional tax on the deemed transaction in the form of a secondary adjustment. The DGT can make secondary adjustments as a consequence of the primary adjustments, as per the prevailing regulations.

Specified methodologies for testing intragroup service transactions

The regulations provide that intragroup services may be tested using the comparable uncontrolled price method (CUP), the cost plus method, and the transactional net margin method. In an example used in PER-22 to illustrate the performance of an analysis for testing the fairness of the payment for services, an analysis of the cost base of the service provider is required, implying that the tax authorities may seek information relating to the cost base of the service provider.

Increased requirements for intangible asset transactions

The regulation provides a four-step approach to test the transfer of intangible assets by taxpayers:

- Identifying the existence of intangible assets;
- Identification of the value of the intangible assets;
- Factual study whether intangible asset has been transferred; and
- Determination of fair compensation.

In addition to the five specified methods – the CUP, the resale price method, the cost plus method, the profit split method, and the transactional net margin method – the DGT has also formalized its approval of certain additional methods, such as the income-based approach, the cost based approach, and the market based approach to test the fairness of transfers of intangible property.

The regulations also draw specific attention to the gathering of additional data to evaluate the role of intangible assets in the taxpayer's business and the contribution made by the taxpayer in developing these intangibles.

Additional requirement for loan transactions

The new regulation specifies that only the CUP method may be used to price intragroup loan arrangements, and provides that the following factors will be important in evaluating such arrangements:

- An analysis as to the need for the loan;
- Ensuring that the loan from the related party actually occurred;
- The fairness of the debt-to-equity ratio; and
- The arm's length nature of the interest expense.

Forms

The regulation recommends the use of 10 forms the taxpayer must complete during the conduct of an audit. While some of these forms were already being used by tax auditors, some may pose an additional burden on taxpayers, including required information on segmented financial statements, a supply chain management analysis of the taxpayer, functions, assets, and risk analysis, and a comparability analysis.

These forms must be submitted within seven days from the date of receipt of the request.

— Roy David Kiantiong (Jakarta)
Partner
Deloitte Indonesia
rkiantiong@deloitte.com

Carlo L. Navarro (Singapore)
Director of Taxes
Deloitte Singapore
canavarro@deloitte.com

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