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Global Transfer Pricing

Arm's Length Standard

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In this issue:

New OECD Draft on Transfer Pricing Aspects of Intangibles

The OECD on 30 July 2013 issued a revised discussion draft on Transfer Pricing Aspects of Intangibles for public consultation. This is part of the OECD's ongoing project to update and clarify the intangibles chapter of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and it is much changed from the initial draft issued in June 2012.

This work is a key part of the OECD's broader project, supported by the G20, to address base erosion and profit shifting (BEPS) within the international tax system. Transfer pricing forms a significant part of the OECD's 15-point Action Plan on BEPS; specifically, Action 8 is to ensure that transfer pricing outcomes in respect of intangibles are in line with value creation. The OECD cautions that the new discussion draft should be considered a work in progress and that parts of it may be revised during the course of the work on BEPS.

The discussion draft contains a new draft Chapter VI, Special Considerations for Intangibles for inclusion in the transfer pricing guidelines. The OECD confirms its commitment to the arm's length principle for the pricing of intangibles in the opening remarks, and reflects that it is important that (i) the principles of the OECD transfer pricing guidelines (particularly paragraphs 1.42 to 1.69 covering *inter alia* functional analysis, contractual terms, economic circumstances, and recognition of the transactions actually undertaken) are applied to intangible transactions in the same way as for other transactions; and (ii) the analysis is based on an understanding of the global business and the way in which intangibles are used by the multinational business to add or create value across the entire supply chain.

Highlights of 2013 discussion draft

The revised draft contains a substantially more refined analysis of the factors affecting the valuation of intangibles and fills in many of the gaps in the first draft. However, the revised draft still contains a number of areas in which continued comment and discussion are appropriate.

In general, the revised draft makes a greater attempt to incorporate the existing guidelines. For example, it recognizes that associated enterprises might structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. The revised draft relies on the traditional rules contained in the guidelines for disregarding those transactions. However, a box notes that the OECD is considering as part of the Action Plan whether additional guidance is necessary on the pricing of intangibles whose value is highly uncertain.

Broad definition of intangibles

The revised draft retains the broad definition of intangibles in the previous draft. It rejects traditional legal, accounting, tax, and treaty definitions of intellectual property of intangible assets and states that the transfer pricing definition should not be used in those contexts. The revised draft retains the two-pronged definition of intangibles in the previous draft:

1. Items that are not physical or financial assets, and
2. Items that can be owned or controlled for use in commercial activities.

The key determining factor of whether an asset that is not physical or financial constitutes an intangible is whether independent parties would pay compensation for the asset. The revised draft retains the broad definition of goodwill and going concern value, but adds new language cautioning against merely ascribing residual value to goodwill and assuming that unrelated parties would provide compensation for the unidentified residual value. The draft requires that any transfer pricing analysis relating to a transaction involving intangibles must identify the intangibles with specificity.

Items not considered intangibles

The revised draft retains the exclusion of group synergies, market specific characteristics, and work force in place from the definition of intangibles. The draft adds new guidance to Chapter 1 on those items. Location savings and other market features, such as the size and purchasing power of the local market are considered comparability adjustments. Important guidance is provided on the impact of contractual rights and valuable licenses to do business in a particular country, and new guidance is also provided on group synergies that would generally not be subject to separate compensation. Examples of group synergies address purchasing hubs and the determination of the arm’s length interest rate for intercompany loans. (The interest rate examples adopt many of the principles discussed in the Canadian case, *GE Capital of Canada*.)

Return on intangibles

This revised draft retains many of the basic concepts of who is entitled to intangible returns. The revised draft reiterates that the question of legal ownership is separate from that of remuneration under the arm’s length principle. The legal owner of an intangible is entitled to all returns attributable to the intangible if and only if it:

a. Performs and controls important functions (design and control of research and marketing programs, management and budgetary control over strategic decisions regarding the intangible development program, decisions regarding defense and protection and ongoing control over other functions that are outsourced) related to development, enhancement, maintenance, and protection of intangibles;
b. Provides all assets necessary to develop, enhance, maintain, and protect the intangibles; and
c. Bears and controls all related risks and costs.

The revised draft clarifies that the legal owner may outsource to related or unrelated parties many functions involved in the development of intangibles. However, if a related party performs or controls functions related to development, enhancement, or maintenance or protection of the intangible, the related party may be entitled to a share of the anticipated intangible return. Similarly, the revised draft states that when the legal owner outsources most or all of the important functions to related parties, the entitlement to a material portion of the intangible returns is highly doubtful.

The revised draft recognizes for the first time that funding intangible development and bearing the risk associated with the outcome are entitled to compensation. The draft cautions that funding intangible development and bearing the risk of success without any control over the use of the contributed funds generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested, but no more. Presumably, the funder would be entitled only to its *ex-ante* expected return but no more. Any remaining *ex-post* returns would belong to the other related parties that performed all other important functions. The funder would incur losses if the development activity was unsuccessful.

The revised draft adds a new section on returns attributable to research and development and use of a company's name. The revised draft reiterates previous Article VII guidance that use of a corporate name simply to denote membership in a group is not compensable. To receive compensation, the legal owner must demonstrate the financial benefit received by the user and the relative contribution of the user and the legal owner to the value. Interestingly, the revised draft states that in an acquisition, it should not be assumed that the acquiring company would pay for the use of the name. The draft suggests that, in some circumstances, the acquiring company may receive a greater benefit from the acquired company using the name and, therefore, the acquiring company should make a payment to the acquired company.

Transfer pricing methods

The revised draft retains the requirement that any analysis should consider "options realistically available"; in other words, a two-sided transfer pricing analysis in which the alternatives of both parties are considered. The revised draft newly states that the reliability of a one-sided analysis for companies performing the important functions discussed above is likely to be substantially reduced. Thus, the reliability of transfer pricing analysis that considers only the return to a contract research organization that determines the design of the research, makes strategic decisions, and manages and controls the research budget is likely to be substantially reduced. The revised draft cautions that valuation for accounting purposes may be inherently conservative. Thus, purchase price allocation performed for accounting purposes are not determinative for transfer pricing. Specific reference to D.1.(vi) intangibles, which were to be valued in an unspecified special method, no longer exists.

In general, the description of the methods and considerations to be taken into account are now more consistent in tone and approach with the other sections of the guidelines. This draft reiterates that depending on the facts, any of the five OECD transfer pricing methods may constitute the most appropriate method. It provides no new guidance on the application of the profit split method, even though the revised draft suggests that a profit split method would be the most reliable method in many cases.

The revised draft cautions against the use of allocating nonroutine income in perpetuity in situations in which the intangible in question has an indeterminate useful life. The draft requires a thorough analysis of the useful life of an intangible based on facts and circumstances. It recognizes that an intangible may have value as a platform beyond such time when products incorporating such intangible cease to be marketed.

Timetable and next steps

Interested parties are invited to submit comments on the discussion draft by 1 October 2013. Comments should be sent in Word format to TransferPricing@oecd.org. The OECD intends to hold a further public consultation on the revised discussion draft in Paris in November 2013.
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OECD Releases White Paper on Transfer Pricing Documentation

The Organization for Economic Development and Cooperation on 30 July 2013 released a 42-page white paper on transfer pricing documentation as part of its project on transfer pricing simplification, and invited interested parties to submit comments on the same by 1 October 2013.

The white paper sets out:

- An overview of the existing guidance and initiatives, including local country documentation regimes and guidelines adopted by international organizations (such as the EU 'masterfile' concept and the Pacific Association of Tax Administrators' documentation package). The section also includes a summary of comments from business representatives on the burdens imposed by differing documentation requirements. This section concludes that "clearly, it seems that there is room for improvement."
- The purposes of transfer pricing documentation requirements, and lists three reasons for transfer pricing documentation: to allow tax authorities to conduct an informed risk assessment, to ensure that taxpayers have given appropriate consideration to transfer pricing in their tax returns, and to provide to the tax authorities all the information that might be required for a thorough transfer pricing audit.
- Suggestions for modifications to transfer pricing documentation rules to meet the goals of simpler compliance for business and more useful information for tax authorities. The OECD proposes a two-tier approach – the "Coordinated Documentation Approach" – that would involve a masterfile provided to all relevant tax authorities and a local file. The masterfile portion of the documentation would provide "big picture" information to enable tax authorities to undertake a risk assessment, whereas the local file would supplement the masterfile with information regarding individual transactions and their functional and economic analyses.
- Development of a coordinated approach to documentation. This area is the least developed so far, and the OECD acknowledges the challenges of local requirements within national tax systems. Further work is proposed.

The OECD's invitation to comment aims to launch a global conversation on how transfer pricing documentation rules can be improved, standardized, and simplified. The OECD also invited comments on whether other mechanisms can be developed to comply with the transfer pricing documentation elements of the Base Erosion and Profit Shifting (BEPS) action plan.

The OECD will hold a public consultation on the white paper in November 2013.

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The New Transfer Pricing Landscape in Australia

Australia's transfer pricing landscape has changed dramatically in recent years. The enactment of new transfer pricing laws (the new laws) – part of the most significant overhaul of Australia's transfer pricing rules for 30 years – has been accompanied by the Australian Taxation Office's establishment of a new anti-profit-shifting taskforce and notification of a significant increase in ATO investigations of multinational corporations (MNCs) operating in Australia.

Uncertainty regarding the ATO's enforcement of the new laws, coupled with increased ATO scrutiny of MNCs' tax structures and transfer pricing practices, means that MNCs need to understand how the new laws apply to them and consider what steps to take to prepare for the possibility of future ATO transfer pricing review.

This article comments on key features of the new laws, the new ATO taskforce, the substantial increase in profit-shifting risk reviews and audits flagged by the ATO, and identifies some important practical considerations arising from the new laws' operation. Our comments are focused on what is different under the new laws, including what practical measures taxpayers should take to respond to the changing transfer pricing environment in Australia.

Key Takeaways: The new transfer pricing laws	
Commencement	Australia’s new transfer pricing laws apply to tax years commencing on or after 1 July 2013.
Profit focus	The new laws focus on arm’s length profit and profit allocation, as opposed to the arm’s length pricing of transactions.
	This may give the ATO broader powers to attack loss-makers, given the ability to inquire into whether profit outcomes are commercially realistic.
Reconstruction	The new laws give the ATO broader reconstruction powers, and there is considerable uncertainty as to how those powers will be applied.
	Conditions between international related parties must be consistent with those that would have been in place between independent entities in comparable circumstances; otherwise, the reconstruction rules may apply.
Self-assessment	Public officers must determine their businesses’ compliance with the new laws before signing and lodging their tax returns.
	When non-arm’s-length pricing has led to insufficient Australian taxable income, “upward” transfer pricing adjustments have to be self-assessed – either through the accounts before year end, or in the tax return.
	When non-arm’s-length pricing has led to excessive Australian taxable income, “downward” transfer pricing adjustments cannot be self-assessed post- year-end in the tax return.
Documentation	Failure to prepare transfer pricing documentation by the time the tax return is lodged means a reasonably arguable position (RAP) cannot exist for penalty purposes.
	There is significant uncertainty on what transfer pricing documentation must contain for taxpayers to have a RAP.
Finance	Arm’s length interest rates on inbound related-party debt must be based on rates that would have applied to notional arm’s length amounts of debt.
Time limit	The new laws include a seven-year time limit on the commissioner of taxation’s ability to amend assessments to give effect to transfer pricing adjustments.
OECD guidance	The new laws must be applied so as best to achieve consistency with the OECD’s transfer pricing guidelines.

Key Takeaways: The New ATO Task Force and Increased Audit Activity Key takeaways – the new ATO task force and increased audit activity
The ATO has established a new, anti-profit-shifting taskforce that has two key functions: • Working with foreign tax authorities to investigate the substance of the operations of Australian MNCs’ offshore affiliates; and • Investigating whether highly profitable global MNCs doing business in Australia are deliberately avoiding tax.
The ATO will undertake 60 new audits of MNCs in the next few years. Key targets are restructures that route profits away from Australia and to low-tax countries or tax havens. The ATO has flagged 125 risk reviews and 26 audits focused on profit-shifting in 2013-14.

The new transfer pricing laws

The enactment of the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 on 29 June 2013 heralded a new era in transfer pricing in Australia.

The new laws have arrived against a backdrop of international focus on base erosion and profit shifting (BEPS), with the G8, G20, and the OECD all agreeing on the need for action to curtail this problem, through avenues including transfer pricing actions. The new transfer pricing laws form part of a package of legislation, together with new general anti-avoidance provisions, highlighting the Australian government’s treatment of transfer pricing as a major tax avoidance issue.

The new laws (subdivisions 815-B, 815-C, and 815-D of the Income Tax Assessment Act 1997) apply to income years commencing on or after 1 July 2013, prospectively replacing the former laws in division 13 ITAA 1936 and subdivision 815-A ITAA 1997. Subdivision 815-B applies to entities, 815-C to permanent establishments, and 815-D to partnerships and trusts. The new legislation is essentially the same as the bill introduced in February 2013. (*See* the previous Deloitte transfer pricing alert on that bill).

URL: http://www.deloitte.com/view/en_AU/au/services/tax/publicationsandevents/publications/4170a7c48463d310VgnVCM2000003356f70aRCRD.htm?id=us:em:na:als:eng:tax:081213

The stated goals of the new laws are to modernize Australia's transfer pricing rules and to bring them into line with international standards and best practices. While this is a positive move, the downside is that there is considerable uncertainty as to the scope of the new laws and how the ATO might apply them in practice. To alleviate some of this uncertainty, the ATO is drafting guidance on two key aspects of the new laws: reconstruction and documentation.

New subdivision 815-B applies when an entity gets a transfer pricing benefit, which is essentially defined as a lesser tax outcome due to the cross-border conditions of its commercial or financial relations with another entity differing from arm's length conditions. When that is the case, the new provision substitutes the arm's length conditions for the actual conditions. "Arm's length conditions" are the conditions, including the price, gross margin, net profit, and the division of profit that might be expected between independent entities dealing wholly independently with one another in comparable circumstances.

The focus on arm's length profit and profit allocation is a key difference with the former laws in Division 13 ITAA 1936, which focused on the arm's length consideration of transactions. This potentially opens the door for a broader inquiry as to whether a taxpayer's profit outcomes are "commercially realistic," notwithstanding that particular cross-border related-party transactions may reflect market prices.

Some important practical implications of the new laws are explored below.

The new ATO task force

The ATO has announced the establishment of a new task force to investigate corporate tax evasion, including evasion through profit shifting.

Details on the form of the task force have not yet been finalized. However, *The Age* newspaper reports[1] from an interview with the new Commissioner of Taxation, Chris Jordan, that part of the new unit's role will be to work closely with foreign tax authorities to establish the purpose and review the operations of Australian businesses in low-tax territories.

This is consistent with other statements from the Commissioner and other senior ATO officers, including:

- The Commissioner recently pledged that the ATO would be intensely scrutinizing complex structures used by multinationals to shift profits to tax havens, including testing that the legal structures match their substance and what is actually happening on the ground; and
- Mark Konza, deputy commissioner, LBI, recently said that the ATO will continue to focus on profit-shifting cases, with a particular emphasis on "those restructures that erode Australia's tax base, including service hubs, alienation of intellectual property, and digital duplication."

The new unit's investigations offshore are likely to involve multicountry audits (which Australia is already involved with in practice) that will test the substance behind companies' assertions of what is happening in foreign countries.

The Age further suggests[2] that the new task force will also investigate whether highly profitable MNCs doing business in Australia are deliberately avoiding Australian tax. This is in line with recent comments from the commissioner, when he suggested that Australian taxpayers reporting less than 1 to 2 percent of their multinational group's global income will be subject to ATO transfer pricing scrutiny.

Establishment of the new ATO task force does not mean that Australian taxpayers cannot restructure their operations to move functions, assets, and risks offshore. What it does mean is that taxpayers engaging in these types of commercial reorganizations must be prepared for ATO review, which generally involves preparing transfer pricing documentation in relation to the restructure itself and the post-restructure transactions. This will include, for example, ensuring that:

[1] *The Age*, 2 July 2013, *Tax Office Casts for Biggest Fish*
[2] *Id.*

- There are robust commercial reasons behind the restructure;
- The transfer pricing model for intragroup pricing is consistent with the actual operations in the offshore territory(ies) post-restructure; and
- Detailed documentation is prepared supporting the commercial rationale for the new structure and the arm's length nature of intragroup pricing and financial outcomes post-reorganization. This will form an important first line of defense if/when the ATO initiates a transfer pricing review.

An example of the type of Australian entity likely to be reviewed is a marketing services provider, when Australian customers buy goods or services from the marketing entity's offshore affiliate, and when that affiliate is located in a low-tax country. It is clear that the ATO intends to review these kinds of structures and that it will challenge relevant financial outcomes when the Australian entity is, in practice, undertaking activities or bearing risks over and above those stated in its intercompany agreements.

Increase in ATO profit-shifting risk reviews and audits

The ATO recently announced[3] that it will open 60 new cases of suspected tax avoidance by Australian and international companies through profit shifting, adding to the 26 investigations of Australian MNCs' offshore restructures already under review. Of the 60 new cases, the ATO has said that 20 are likely to involve entities in the energy and resources sector.

Targets for investigation will be companies that deliberately restructure their operations to route profits through low-tax countries or tax havens to avoid paying higher taxes in Australia, particularly when this involves marketing hubs that have little substance.

Disclosures now required in taxpayers' International Dealings Schedules (IDS) will mean that it is easy for the ATO to identify which Australian taxpayers have undertaken restructures, so these must be designed, implemented, and supported appropriately.

Furthermore, the ATO's *Compliance in focus 2013-14* report,[4] released on 16 July 2013, reveals the ATO's view that "profit shifting is becoming increasingly common… " and confirms that profit shifting will be very high on the ATO's review and audit activity agenda for the next 12 months. This report indicates that, in the coming year, the ATO will undertake profit-shifting risk reviews and audits in relation to more than 150 MNCs. A further 680 reviews and 115 audits will be performed by the ATO in relation to Australian entities' tax-haven related activities.

As a result of this impending ATO review activity, MNCs are likely to place a premium on being prepared for reviews, obtaining certainty and effectively managing any disputes that do occur, particularly having regard to potential disruption to their business. Advance pricing arrangements (APAs) can be a good option for taxpayers that seek to avoid time-consuming transfer pricing disputes and that wish to obtain certainty on transfer pricing filing positions before relevant tax returns are lodged – particularly when restructures are involved. However, the ATO appears to be becoming more discerning about which APA applications should be accepted into the program, and has recently questioned some applications involving restructures, so APAs (particularly unilateral) may not always be a readily available option.

Key practical implications of the new transfer pricing laws

Although the new laws maintain adherence to the arm's length principle, several significant changes have been introduced. Australian taxpayers with international related-party dealings should have regard to these changes and how they affect their existing transfer pricing policies and filing positions. Outlined below are our views on how historical transfer pricing practices will be most affected by the new laws, and what taxpayers should do to best protect themselves from ATO transfer pricing review and challenge.

New ATO powers of reconstruction – The aspect of the new laws causing most concern involves the provisions in Subdivision 815-B that deal with nonrecognition and reconstruction of actual related-party transactions and arrangements. Subdivision 815-B requires that arm's length conditions be determined having regard to both the legal form and the substance of the arrangements, and also whether independent parties in comparable circumstances would have entered into those arrangements. This is not just a reconstruction power for the ATO; subdivision 815-B requires an entity to self-

[3] The Age, 6 July 2013, *Scrutiny on the bounty: tax probe on global giants*

[4] http://www.ato.gov.au/uploadedFiles/Content/CS_C/downloads/CSC35735NAT74689.pdf

assess its tax outcomes on the basis of arm's length conditions, so that taxpayers must address these matters in preparing their tax returns.

Subdivision 815-B legislates the relevance of economic substance in applying the arm's length principle. The provision includes a specific reconstruction rule that essentially requires that arm's length conditions be determined based on what independent parties might be expected to have done in comparable circumstances. The principal concern is that the reconstruction rule in subdivision 815-B goes beyond what is contemplated in the OECD transfer pricing guidelines.

What's happening in Australia with economic substance, commerciality, and reconstruction under transfer pricing rules can be seen as part of a global trend. Governments and tax administrations are increasingly viewing transfer pricing rules as anti-abuse measures. The line between transfer pricing rules and general anti-avoidance rules is becoming increasingly blurred. There seems to be considerable overlap in these rules for tax auditors when imposing their views on commerciality and what makes commercial sense. "What's the commercial rationale for that?" is the first question ATO auditors may now ask when faced with the transfer pricing of a multinational's business restructure, financing arrangements, or loss-making operations.

Too much emphasis on the ability of a tax administration to reconstruct transactions (outside of exceptional circumstances as emphasized by the OECD transfer pricing guidelines) encourages second guessing of business decisions by tax auditors. It invites them to ask the question: "Why did you do it like that?," and to answer it with "you could have made more profits if you'd done it like this, so that's what an independent party would have done and that's what we'll be taxing you on." The concern here is the tension that will arise if/when the ATO tries to tell taxpayers how to run their businesses.

In a reconstruction context, the ATO inquiry will become whether the controlled transaction has economic substance, whether it makes commercial sense, and whether it would be entered into by independent parties acting in a commercially rational manner. In evaluating this, emphasis will be placed on the availability of comparables, and the need to consider such matters as the options realistically available to the parties, their relative bargaining power, and which party "controls" relevant risks.

The world of transfer pricing is increasingly being populated with laws and guidelines that liberally use concepts such as economic substance, reconstruction, commercial sense, commercially realistic outcomes, options realistically available, and bargaining power. It seems that as thinking on the arm's length principle evolves, its inherent uncertainty increases, bringing with it the inevitable potential for differing views, greater disputes, and unrelieved double taxation for multinationals.

One sure thing under the new rules is that Australian taxpayers' pricing policies with international affiliates must reflect the underlying substance of the parties' commercial relationships – and that such relationships must be consistent with those that would have been entered into by independent entities in comparable circumstances. Also, regular reviews of whether operating models remain consistent in practice with the models originally implemented will become increasingly important.

What should taxpayers do?

- Review whether transfer pricing arrangements are in line with the economic substance of the arrangement.
- Consider whether transactions or financial relations would have been entered into by independent parties in comparable circumstances. The new rules do not require related parties to choose options that have the highest tax outcomes, but the commercial thinking behind why such options were considered and rejected should be documented.
- Document and maintain analysis of the above in transfer pricing records.
- Monitor forthcoming ATO guidance on the practical operation of the new reconstruction provisions.

Transfer pricing in a self-assessment environment – The new laws apply on a self-assessment basis. This means that taxpayers will now have to do the work to determine whether their international related-party arrangements are arm's length before lodging their income tax returns.

When non-arm's length pricing results in lower taxable income in Australia, taxpayers will be expected to self-assess transfer pricing adjustments to increase taxable income. This will place additional pressure on public officers who are signing tax returns to ensure their entities' compliance with the new laws.

Unfortunately, and unfairly, the new laws do not allow taxpayers to self-assess transfer pricing adjustments that result in lower Australian taxable income. This means that taxpayers' transfer pricing analyses should be performed before year end, so that any pricing adjustments required to lower profits to reflect arm's length outcomes can be put through the statutory accounts, as such adjustments cannot be made through tax returns.

Historically, many Australian taxpayers have commenced preparation of their transfer pricing documentation after year end and hoped that intragroup pricing and financial outcomes were arm's length. Under the new laws, taxpayers should be looking at their budgeted profit and analyzing whether, based on relevant financial and economic circumstances, it will represent an arm's length return. If not, the taxpayer has the whole year to modify its actual prices, or develop arguments as to why its profit result will be different.

What should taxpayers do?

- Self-assess the arm's length nature of transactions/arrangements prior to year end.
- Make pricing or other adjustments prior to year end.
- Focus on the arm's length nature of transactions as they are entered into as well as the commercial basis for the profit outcomes.
- Prepare documentation evidencing and supporting the above prior to lodgement of the relevant income tax return.

New transfer pricing documentation rules – Under the new laws, 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 RAP for penalty purposes. In practice, this means that failure to support a transfer pricing position with contemporaneous transfer pricing documentation will result in the application of a minimum penalty of 25 percent to any subsequent adjustment to taxable income imposed by the ATO.

On this basis, the timing of taxpayers' transfer pricing documentation preparation becomes more important than under the previous rules. As discussed above, this means that transfer pricing analyses should be performed and documented before tax returns are lodged (and preferably before year end, given that transfer pricing adjustments to reduce taxable income cannot be made through tax returns) so that intercompany pricing arrangements and their financial outcomes are supportable as consistent with the arm's length standard. When disclosures are made on taxpayers' IDS that no supporting transfer pricing documentation exists, this effectively means no RAP exists in respect of the transactions concerned.

A lack of transfer pricing analyses and documentation may also have tax governance/risk management implications for companies, including the possibility of having to highlight contestable and material transfer pricing positions to the ATO through a Reportable Tax Position schedule.

In addition to greater emphasis on the timing of preparation of supporting transfer pricing documentation, the content and focus of such documentation will be required to change under the new rules, particularly in respect of substantiating arm's length conditions and aligning the actual conditions to arm's length conditions.

Furthermore, transfer pricing reports prepared offshore for Australian taxpayers will have to be reviewed to ensure that they comply with the new laws. For example, appropriate material regarding the Australian business' operations, transactions, financial results and market conditions will have to be included. This may present a challenge to MNCs that have centralized approaches to the preparation of global transfer pricing documentation. Many MNCs have argued that the headquarters country's transfer pricing documentation requirements have "essentially the same requirements, or more, than just about everywhere else in the world and has about 95 percent of the information needed, save for a handful of exception jurisdictions." Under Australia's new rules, these practices may not be good enough to enable the local Australian operations to have a RAP for penalty purposes.

What should taxpayers do?

- Undertake transfer pricing analyses and prepare supporting documentation prior to lodgement of the relevant income tax return.
- Ensure transfer pricing documentation is of a standard that will provide a RAP.
- Monitor forthcoming ATO guidance on transfer pricing documentation and RAP requirements.

New transfer pricing rules regarding intragroup finance – Under the new laws, intragroup financing is one of the more complicated and uncertain areas of Australian transfer pricing.

The financing aspects of the new laws are intended to give legislative support to the ATO's views on this in Taxation Ruling TR 2010/7. This effectively means that identification of an arm's length interest rate requires determining an arm's length creditworthiness for the borrower, which in practice can often require establishing whether the taxpayer's capital structure is arm's length. The resulting pricing may be based not on the actual debt amount, but on an arm's length debt amount.

Recent ATO and Treasury statements clearly suggest that the ATO will maintain its current review focus on intragroup debt, particularly when it involves hybrid instruments. In this environment, it is critical that taxpayers with material amounts of international related-party debt review the debt's pricing to ensure it complies with the new transfer pricing rules. In particular, when thin capitalization rules apply, arm's length interest rates on inbound debt must be determined based on the rate that would have been applied to a notional arm's length amount of debt.

The commercial realism of the debt amount/capital structure also needs to be considered in light of the ATO's comments in TR 2010/7 regarding whether the capital structure results in a commercially realistic arm's length profit outcome.

In addition, having regard to proposed reduction to Australia's thin capitalization safe harbors in the recent federal budget, it is possible that the use of the arm's length debt test may increase, as taxpayers look for ways to support their interest deductions in light of the planned reduction in the safe harbor debt-to-equity ratio.

What should taxpayers do?

- Look beyond just the price of the loan.
- Consider the arm's length nature of the debt/capital structure.
- Price international related-party loans according to notional arm's length amounts of debt.
- Consider whether post-interest profitability is "commercially realistic."
- Document the above analyses prior to lodgement of the relevant income tax return.

The ATO's approach to loss makers – Subdivision 815-B seems intentionally drafted to be capable of authorizing an ATO approach (such as in the *SNF Australia* type of scenario) of treating the incurring of losses that could not be sustained by independent parties as in itself evidencing non-arm's-length conditions, whether or not those losses arise from third-party or even domestic transactions.

We are increasingly seeing the ATO take questionable positions on loss-making subsidiaries, including the view that the economic rationale for the existence of a subsidiary is to add to the profitability of the multinational enterprise, so that if the subsidiary is in a situation of systemic loss (for whatever reason) and requiring parental financial support, it is to benefit the multinational in some unidentified manner and not arm's length by definition. It is sufficient for subdivision 815-B purposes under this approach to have commercial or financial relations between the Australian subsidiary and its foreign parent to which to connect the conditions. In some cases it has been suggested that the subsidiary is performing a service for the parent in this regard and should be compensated by way of a service fee (see, for example, the SNF Australia Decision Impact Statement issued by the ATO).

At the extreme, it could be argued that this ATO thinking equates the arm's length principle with a requirement to earn profits. In the ATO's view of the world, there's something inherently non-arm's-length about making a loss. Such thinking is facilitated by subdivision 815-B's explicit description of profits and the allocation of profits as "conditions" for purposes of applying the provision.

What should taxpayers do?

- Consider the commercial (i.e., non-transfer pricing) drivers of losses/low profits.
- Include an analysis of commercial reasons for losses/low profits, as well as pricing, in the transfer pricing documentation.

Time limit for transfer pricing amendments – Previously there has been no limitation on the period in which the commissioner could amend an assessment to give effect to a transfer pricing adjustment. A seven-year amendment period is included in the new laws.

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.

Conclusions

Recent developments ensure that transfer pricing will remain a key priority for the ATO. This is particularly so now that the new laws and the new anti-profit-shifting task force are in place and that the ATO has flagged a significant number of profit-shifting risk reviews and audits in 2013-14. This focus on transfer pricing is likely to be reinforced by the current interest in MNCs' transfer pricing arrangements from community groups, the media, government, and global tax authorities.

The changing global tax environment for MNCs gives rise to significant challenges for dealing with transfer pricing issues, and the introduction of new Australian transfer pricing laws means that it is now more important than ever for taxpayers to ensure they are satisfied that their prices and financial outcomes reflect arm's length conditions and that their cross-border arrangements are commercial. The new Australian transfer pricing landscape has arrived and Australian taxpayers need to ready themselves for it.

As a final comment, we note the possibility that global and Australian transfer pricing guidance could change further, as a result of the OECD's and Australian Treasury's BEPS projects. Further commentary on BEPS is expected from these bodies shortly. We await this commentary with interest.

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Brazil Updates Transfer Pricing Rules for Financial Transactions

The Brazilian Ministry of Finance issued a ruling on 2 August 2013 (Ruling 427/2013) that defines and clarifies the "spreads" that should be taken into account for transfer pricing purposes. The spreads apply to interest charged in the context of related-party financial transactions.

New transfer pricing rules specifically addressing interest paid on related-party financial transactions were published in December 2012 (Law 12,766/2012) and the Ministry of Finance was charged with issuing guidance on the applicable spreads. Before the rules came into effect on 1 January 2013, interest paid on related-party financial transactions were outside the scope of the Brazilian transfer pricing rules if the relevant transaction was registered with the Brazilian central bank.

Law 12,766/2012 established the interest rates that should be applied as a "stand-in" to determine the reasonableness of interest expense or income associated with related-party financial transactions, and provided that such rates should be applied in conjunction with a spread component to be determined by the Ministry of Finance. Because no guidance was issued until 2 August, taxpayers and tax practitioners have been uncertain as to how to correctly apply the new transfer pricing rules on related-party financial transactions. For example, it was unclear whether there would be different spreads for each type of transaction or just one fixed margin, and when and how often the spread(s) would be published.

The basic rule under Law 12,766/2012 is that the interest "limitation" on financial transactions (a maximum for inflows and a minimum for outflows) is a combination of a "rate" plus a "spread." Different rates apply, depending on the type of transaction, currency used, and other factors. The rates are defined as follows:

Currency	Market	Type	Rate Limit
USD	Foreign	Fixed rate, predetermined	Market rate of sovereign bonds of Federative Republic of Brazil, issued in USD, in foreign markets
Real	Foreign	Fixed rate, predetermined	Market rate of sovereign bonds of Federative Republic of Brazil, issued in reais, in foreign markets
Any*	Any*	Any*	Libor for six months for the respective currency adopted**
Real	Foreign	Variable	May be determined by the Ministry of Finance
* The Libor limit considers the adoption of any currency, market, and type resulting in different combinations other than those specified for other rate limits. ** If there is no specific Libor for the currency adopted, the six-month Libor in U.S. dollars should be used.			

The spread component that must be taken into consideration when applying the above rates has now been determined by the Ministry of Finance. The spread varies depending on the nature of the financial transaction under analysis (inbound or outbound). For inbound financial transactions, when the Brazilian taxpayer is paying interest to a foreign related party, the annual spread is limited to maximum rate of 3.5 percent. For outbound financial transactions, when the Brazilian taxpayer is receiving interest from a foreign related party, the annual spread is limited to a minimum rate of 2.5 percent. The basis on which these rates were assigned by the Ministry of Finance is unclear.

The MOF acknowledges the lack of guidance during the first seven months of 2013, and Ruling 427/2013 establishes that the spread applicable to intercompany outbound financial transactions for the period from 1 January 2013 through 2 August 2013 is 0 percent. In other words, the 2.5 percent spread on outbound financial transactions applies for the period from 3 August 2013 to 31 December 2013.

Because transfer pricing in Brazil is assessed on a calendar-year basis, the application of a 0 percent spread for the first seven months of the year should benefit taxpayers entering into intercompany outbound financial transactions (to the extent it lowers the minimum interest revenue requirement in Brazil).

Conclusion

Ruling 427/2013 addresses most of the outstanding questions taxpayers and tax practitioners have had about the application of the transfer pricing rules to financial transactions. However, the ruling fails, to address outstanding issues regarding the application of the limit rates in the table in relation to the size, term, and other significant economic fact patterns of transactions. Taxpayers should consider the appropriate interest limit at the time a contract is concluded and ensure that the relevant spreads are observed for each calendar year under analysis.

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France Considers Amendments to Transfer Pricing Documentation Requirements

The French Parliament is in the process of making significant changes to the transfer pricing documentation requirements, in the context of a fiscal crisis and the fight against tax evasion. Proposed legislation that has already gone through a vote in the National Assembly would require the compulsory attachment of transfer pricing documentation to the corporate income tax return.

Current rules

Under the current provisions of Article L 13 AA of the French Tax Procedure Code, transfer pricing documentation is compulsory in France for fiscal years starting on or after January 1, 2010. Article L 13 AA applies to French entities that belong to groups that meet certain size criteria (that is, if the French entity, one of its direct or indirect owners, or one of its direct or indirect subsidiaries has a turnover or gross assets exceeding EUR 400 million).

French entities that have cross-border transactions with foreign affiliates must have complete documentation available on the first day of a tax audit. A 30-day grace period is granted by the tax authorities if the documentation is not provided upon request. Failure to provide complete documentation during the tax audit will result in a minimum penalty of EUR 10,000 per year, which may be increased to up to 5 percent of the transfer pricing adjustment, if any. All cross-border transactions must be documented regardless of size and nature.

Proposed changes for fiscal year 2013

On June 20, 2013, the National Assembly, one of the two chambers of the French Parliament, approved changes to Article L 13 AA requiring companies to attach their transfer pricing documentation to the annual corporate tax return. Changes to Article L 13 AA would be final once they are approved by the Senate. A vote by the Senate was originally scheduled for July 18, 2013.

On July 18, the Senate proposed a different text, which would have required taxpayers to file a disclosure form no later than six months after filing the tax return. This disclosure form would have been in addition to the transfer pricing documentation requirement. In other words, it was not a substitute to the transfer pricing documentation requirement. Because the National Assembly and the Senate could not reach an agreement on time, debate on this measure was postponed until September.

The proposed legislative changes are likely to be enacted, in light of the government's support and the negative publicity surrounding transfer pricing.

Consequences and expected additional legislative changes

If enacted, the pending legislation would force companies to attach their documentation to the corporate income tax return, which is typically due three to four months after fiscal year-end. Failure to comply would result in penalties, even if no transfer pricing adjustment is made upon tax audit.

The French government already indicated that it would submit additional legislative changes to Parliament during the fall of 2013 to increase documentation penalties, potentially making them proportional to the volume of transactions regardless of whether there is an adjustment upon tax audit. If these changes are enacted, France would have some of the most stringent transfer pricing documentation requirements of the OECD countries.

In addition to changes to transfer pricing documentation, the government is also expected to seek changes to the transfer pricing legislation to shift the burden of the proof onto taxpayers in situations such as the transfer of functions and risks outside of France.

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Malaysia's 2013 Transfer Pricing Audit Framework – A Primer

The Malaysian Inland Revenue Board has issued a Transfer Pricing Audit Framework that is effective for the period beginning on or after 1 April 2013. The primary objective underlying the release of this framework is espoused in the introductory part of the document. The framework "aims to ensure that cross-border and local transfer pricing audits are carried out in a fair and transparent manner in accordance with the provisions of the Income Tax Act, 1967."[5] The framework is applicable to both cross-border and domestic transactions entered into by the taxpayer with related entities.

The framework defines a transfer pricing audit as "an examination of a taxpayer's business records and financial affairs to ascertain the application of the rules on controlled transactions".[6]

Before the release of the framework, the guidelines for the conduct of transfer pricing audit were embedded within the confines of the erstwhile Tax Audit Framework, 2009. With the issue of the Framework, there now exists a separate, standalone guidepost dealing exclusively with the conduct of transfer pricing audits.

This article highlights the salient features of the framework, and provides broad guidance to taxpayers regarding the possible mechanisms to be adopted while gearing up for a transfer pricing audit exercise

Types of Transfer Pricing Audits[7]

The framework groups transfer pricing audits into the two main categories – desk audits and field audits.

Desk audits are conducted by the IRB at their premises via correspondence with the taxpayer. These audits are in the nature of compliance relating to transfer pricing issues.

Field audits, on the other hand, are conducted at the taxpayer's premises. A field audit involves an examination of the taxpayer's business records to determine the arm's length nature of the controlled transactions. A taxpayer will be issued a notice prior to a field audit.

Years of Transfer Pricing Assessment[8]

Consequent to the amendment effected to Section 91(1) of the Income Tax Act 1967 (the Act), the years of assessment to be covered in a transfer pricing audit are restricted to five years of assessment. This amendment is effective from 1 January 2014.

Selection of Cases[9]

The key determinant for the selection of cases for transfer pricing audit, as stipulated by the framework, is the value of controlled transactions between related companies. Prior to the commencement of a transfer pricing audit, the selected cases must be approved by the Selection Committee.

Field Audit Procedure[10]

The following flowchart illustrates the various steps postulated by the framework for the conduct of a field audit:

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[5] Paragraph 1.1 of the Transfer Pricing Audit Framework, 2013
[6] Paragraph 4.1 of the Transfer Pricing Audit Framework, 2013
[7] Paragraph 4.1.1 of the Transfer Pricing Audit Framework, 2013
[8] Heading 5 of the Transfer Pricing Audit Framework, 2013
[9] Heading 6 of the Transfer Pricing Audit Framework, 2013
[10] Heading 7 of the Transfer Pricing Audit Framework, 2013

Taxpayer is issued an audit notice. The period between the notice and the audit visit is 14 days

An audit visit normally commences with an interview. The taxpayer is required to explain its business activities and recordkeeping systems.

The audit officers inspect the business records, stock, and equipment. Records pertaining to time-barred years of assessment would not be examined.

The audit officers do not take possession of any documents or records; however, the audit officers can request photocopies of the requisite documents/records.

The time required to complete the examination process varies from four to five days. The time period may be extended, depending on the complexity of the case and the co-operation extended by the taxpayer.

After conducting the audit work, an Audit Findings Report is prepared. This report needs to be approved by the Branch Audit Manager. The audit officer, together with at least one senior officer, would discuss the propose adjustments with the taxpayer.

In the event tax adjustments are to be made, a notification detailing the proposed adjustments along with the underlying rationale is issued to the taxpayer to enable it to express its views and provide clarifications/explanations.

Finally, a notice of additional assessment with the appropriate penalty is issued to the taxpayer. If there is no adjustment, an audit finalization letter without adjustments is issued. Audit cases that are settled would be monitored through compliance reviews for ensuring adherence to the arm's length principle.

Rights and Responsibilities[11]

The framework provides detailed guidelines dealing with the rights and responsibilities of both the IRB as well as the taxpayer in relation to a transfer pricing audit. The taxpayer must comply with the duties as set out under Public Ruling 7/2000 during the course of a transfer pricing audit. If the taxpayer appoints a tax agent other than the one currently appointed for the compliance audit, the taxpayer must submit a copy of the letter of appointment as required under Section 153 of the ITA.

[11] Heading 8 of the Transfer Pricing Audit Framework, 2013

Offences and Penalties[12]

In the event of an understatement or omission of income, a penalty will be imposed under subsection 113(2) or paragraph 44B (7) (b) of the Act under which the penalty rates equal the amount of tax undercharged (being 100 percent) accordingly.

The framework also provides for a concessionary rate of penalty when taxpayers make a voluntary disclosure. Such a voluntary disclosure must be made in writing to the Director of Multinational Tax Department/relevant Branch Director of IRBM. Upon voluntary disclosure, the taxpayer will still be required to prepare transfer pricing documentation.

The concessionary penalty rates for voluntary disclosure for transfer pricing issues are tabulated below:

Condition	Rates of Penalty (in %)		
	Normal	Voluntary disclosure after the taxpayer has been informed but before commencement of audit	Voluntary disclosure before the case is selected for audit
Understatement or omission of income	45	35	15
Nonpreparation of transfer pricing documentation	35	30	15
Transfer pricing documentation prepared but not in compliance with the transfer pricing guidelines	25	20	10
Preparation of comprehensive, good quality, contemporaneous transfer pricing documentation in accordance with the Guidelines	0	0	0

For each repeated offense, the rate of penalty increases by 20 percent compared to the last penalty rate imposed for the previous offense, but limited to a sum not exceeding 100 percent of the total amount of tax undercharged.

Mutual Agreement Procedures[13]

The framework provides that taxpayers residing in Malaysia can apply for assistance from the competent authorities in Malaysia by availing themselves of the Mutual Agreement Procedure mechanism, in respect of issues arising from transfer pricing audit, when adjustments affect cross-border transactions with related companies in any treaty partner country.

Offsetting Adjustment[14]

Any additional adjustments regarding transfer pricing for a particular assessment imposed on the taxpayer in a controlled transaction can be presented with an offsetting adjustment on the assessment of the related party in the same transaction.

Appeals[15]

Any taxpayer aggrieved by assessments raised by the IRB can appeal the assessment to the Special Commissioners of Income Tax within 30 days after service of the notice of additional assessment.

Conclusion

The Transfer Pricing Audit Framework, 2013, is a welcome step in the right direction to minimize the possibility of protracted litigation between the tax administration and taxpayers because of transfer pricing issues.

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[12] Heading 10 of the Transfer Pricing Audit Framework, 2013
[13] Heading 13 of the Transfer Pricing Audit Framework, 2013
[14] Heading 14 of the Transfer Pricing Audit Framework, 2013
[15] Heading 15 of the Transfer Pricing Audit Framework, 2013

The introduction of a specific transfer pricing audit framework would enable taxpayers to be prepared and to take the appropriate measures to ensure that both cross-border and domestic transactions entered into with related parties reflect an arm's length pricing;

The introduction of concessionary rates of penalty subject to voluntary disclosure by the taxpayer takes the color of a dispute resolution mechanism. Although a refreshing innovation, more detailed guidelines need to be formulated by the IRB to clarify the exact nature and scope of this latest feature.

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Hungary Amends Transfer Pricing Documentation Obligations

Hungary's Ministry of Finance recently issued guidance to clarify the country's transfer pricing documentation rules. The amendments to the transfer pricing regime, announced 18 June 2013, clarify the wording of the law in several sections, resolve ambiguity in the interpretation of the law, and ease specific rules.

Among the more significant changes introduced is the amendment to modify the definition of transactions subject to ,the transfer pricing documentation obligation, which will now apply only to transactions whose value exceeds HUF 50 million, calculated at arm's length prices, without taking VAT into account, in the tax year concerned.

Taxpayers will also be exempt from the transfer pricing reporting obligation in the case of transactions covered by an advance pricing agreement in the tax year when the request is filed, the preceding period, and until the last day of the tax year in which the APA ruling expires.

According to the amendment, in the case of cost recharge to several parties of transactions otherwise not subject to the transfer pricing reporting obligation, taxpayers will be required to prove that the method adopted for the allocation of costs is in line with the arm's length principle.

The amendments also clarify the exchange rates to be used to determine the HUF value of payments made in foreign currencies. This conversion is necessary to determine whether the HUF 50 million threshold applies.

The new guidance modifies the range of acceptable profit margins for low value added intercompany services. According to the modified decree, the arm's length price of transactions qualifying as low value added services between related parties will be the price determined using the cost plus method and a 3 percent to 10 percent mark-up, instead of the previous range of 3 percent to 7 percent. Thus, mark-ups between 3 percent and 10 percent will be considered arm's length profit margins.

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Greece Extends Filing Deadlines for Transfer Pricing Documentation

Greece has extended the deadline for the submission of Tax Certificates until 30 September 2013. The extension, introduced by Ministerial Circular (POL.1187/2013, applies to entities with fiscal year ending on 31 December 2012.

Separately, Law 4172, passed on 19 July.2013, extends the deadline for the submission of the Summary Information Table until 16 August 2013. This extension explicitly refers to taxpayers with fiscal years ending on 31 December 2012. For taxpayers whose fiscal years ended after that date, this special deadline does not seem to apply; therefore; for those taxpayers, the general deadline – 50 days after the fiscal year end – would be applicable. However, the Ministry of Finance is expected to clarify the situation soon, and to include fiscal years ending on subsequent dates (up to end of May) under the same deadline extension to 16 August.

The submission of the Summary Information Table requires the use of a special application (xml file), which should meet the specifications set forth by the ministry, as they have been posted on the relevant website of the General Secretariat for Information Systems (GSIS).

Issues raised by Ministerial Decision on Documentation Rules

Ministerial Decision POL 1179/18.7.2013 provides guidance regarding the contents of the transfer pricing documentation file, the liable parties, language requirements, applicable transfer pricing methods, and the content of the Summary Information Table.

However, the main provision of the decision that has already caused a lot of debate is that the exemption from the documentation obligation is shifted from a transaction level, as it is implied by the wording of the law (objective exemption) to the level of the liable taxpayer (subjective exemption). In effect, the wording of the circular does not leave room for any exemption from the transfer pricing documentation obligation, because the exemption applies only to:

- Taxpayers with transactions with one or more related parties not exceeding €100,000 in total, on condition that the turnover of all related parties with which the taxpayer has transactions during the fiscal year do not exceed €5,000,000.
- The above threshold is €200,000 (in total), in case the turnover of the related parties exceed €5,000,000.

The requirement to aggregate transactions to test whether they exceed €200,000 in total or not is contrary to the text of the law itself; from that point of view, the application of the decision is rather problematic. In this context, if all intercompany transactions – viewed as a total and not per category or per counterparty – exceed €200,000, the documentation obligation will cover even minimal transactions of €1.

Further clarifications are expected from the ministry, because this approach is not compatible with the OECD transfer pricing guidelines and international practice.

Until further clarification is provided, taxpayers should pay special attention when compiling their transfer pricing documentation file and the pertinent Summary Information Table.

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Ukrainian President Signs Transfer Pricing Legislation

Ukrainian President Viktor Yanukovich on July 31 signed Law No. 408-VII – previously known as Draft Law on Transfer Pricing No. 2515 – to amend Ukraine's Tax Code and significantly modify the country's transfer pricing regime.

The law had been approved by Ukraine's Parliament on 4 July 2013 upon its second reading.

The new law may be seen as a compromise between the version proposed by the Ministry of Revenues and Duties and proposals suggested by business representatives, given that many of those proposals were only partially considered. Unfortunately, the ministry took a principled stand on a range of critical issues, and its position remained unchanged.

The effective date of the law was changed at the last minute. Thus, the new transfer pricing rules will enter into effect from 1 September 2013, rather than 1 January 2014, as business representatives had requested.

Among the law's salient features is the repeal of the 20 percent safe harbor rule of the market price of comparable goods, the introduction of revised definitions of related persons and controlled transactions, and the introduction of transfer pricing reporting requirements.

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Have a question?
If you have needs specifically related to this newsletter's content, send us an email at **clientsandmarketsdeloittetax@deloitte.com** to have a Deloitte Tax professional contact you.