Global Transfer Pricing

# Arm's Length Standard

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## India Issues Final Safe Harbour Rules

India's Central Board of Direct Taxes (CBDT) on September 19 released its final safe harbor rules, significantly revising the draft rules issued on 14 August.

The final rules contain significant changes to the draft version. From the extent of the changes made in the final rules, it is evident that the CBDT took into consideration the comments received from stakeholders. That consultative and transparent approach in finalizing the rules is encouraging to taxpayers.

### Summary of key changes

The final rules contain the same definitions of various terms such as software development services, information technology enabled services (ITES), intragroup loans, contract research and development services, core/non-core auto components, eligible taxpayer, eligible transactions, operating revenue, and operating profit margin. However, the final rules modify the definitions of knowledge process outsourcing (KPO) services and corporate guarantee, and make a minor change to the definition of operating expenses.

No changes have been made to other provisions of the safe harbor rules, such as nonapplicability of safe harbor rules to international transactions entered into with an associated enterprise (AE) located in a no-tax or low-tax country/territory;[1] no allowance of comparability adjustments; and benefit of arm's length range when opting for the safe harbor rules. The requirement that taxpayers opting for safe harbors maintain detailed transfer pricing documentation has been preserved in the final rules.

The significant changes in the final rules compared with the draft rules are as follows:

[1] Any country or territory notified under section 94A of the Income-tax Act, 1961, or a country or territory in which the maximum rate of income tax is less than 15 percent.

- Removal of turnover threshold for eligibility to opt for safe harbor in case of software development and IT-enabled Services (ITeS) – Under the draft rules, only taxpayers with turnover up to INR 100 crores were eligible for the safe harbor. That turnover cap has been removed in the final rules.
- Change in safe harbor profit margins for software development and ITeS – The final rules prescribe a tiered mechanism for safe harbor margins. A safe harbor profit margin of not less than 20 percent has been specified for taxpayers with turnover of up to INR 500 crores (approx. $80 million); for taxpayers with turnover greater than INR 500 crores, a safe harbor profit margin of not less than 22 percent has been specified.
- KPO services – While the substantive part of the definition of KPO services remains unchanged, the same has been rationalized to mean business process outsourcing services requiring application of knowledge and advanced analytical and technical skills. Further, the safe harbor profit margin for KPO services has been reduced from 30 percent to 25 percent.
- Enhancement in coverage of corporate guarantees – In the draft rules, the safe harbor option was available only for guarantees of up to INR 100 crores. Under the final rules, taxpayers with guarantees exceeding INR 100 crores can also avail themselves of the safe harbor route, provided the credit rating of the borrowing group entity, assessed by an agency registered with the Securities and Exchange Board of India (SEBI), is "adequate to highest safety." The safe harbor commission rate for those guarantees has been prescribed at a minimum of 1.75 percent.
- Period of coverage extended – The prescribed safe harbor margins will be valid for five financial years, beginning in financial year 2012-13, compared to two years, as provided in the draft rules.
- The final rules also include procedural changes, which are discussed below.

The specified circumstances, as well as the margins and rates for all other categories and transactions (for example, contract R&D for the IT and pharmaceutical sectors, auto components manufacturing, and intragroup loans) remain the same.

## Summary of Final Safe Harbour Rules

Under the final rules, the transfer price declared by the "eligible taxpayer" in respect of an "eligible transaction" will be accepted by the tax authorities in the circumstances specified in the table below:

| Eligible Taxpayers / Transactions | Specified Circumstances Under Final Rules |
|---|---|
| Taxpayers engaged in providing software development services, with insignificant risk, to a nonresident associated enterprise (AE)<br>• When the aggregate value of such international transactions does not exceed INR 500 crores (approx. USD 80 million)<br>• When the aggregate value of such international transactions exceeds INR 500 crores | OP/OE* is not less than 20 percent.<br><br>OP/OE is not less than 22 percent. |
| Taxpayers engaged in providing ITES, with insignificant risk, to a nonresident AE<br>• When the aggregate value of such international transactions does not exceed INR 500 crores<br>• When the aggregate value of such international transactions exceeds INR 500 crores | OP/OE is not less than 20 percent.<br><br>OP/OE is not less than 22 percent. |
| Taxpayers engaged in providing KPO services, with insignificant risk, to a nonresident AE. There is no threshold for this category of taxpayers. | OP/OE is not less than 25 percent. |
| Taxpayers engaged in the provision of contract R&D services (wholly or partly) relating to software development, with insignificant risk, to a nonresident AE. There is no threshold for this category of taxpayers. | OP/OE is not less than 30 percent. |

| Eligible Taxpayers / Transactions | Specified Circumstances Under Final Rules |
|---|---|
| Taxpayers engaged in the provision of contract R&D services (wholly or partly) relating to generic pharmaceutical drugs, with insignificant risk, to a nonresident AE. The expression generic pharmaceutical drugs has now been defined in the final rules. There is no threshold for this category of taxpayers. | OP/OE is not less than 29 percent. |
| Taxpayer engaged in the manufacture and export of core auto components / non-core auto component s [when 90 percent or more of total turnover is in the nature of Original Equipment Manufacturer sales]. There is no threshold for this category of taxpayers.<br>• Manufacture and export of core auto components<br>• Manufacture and export of non-core auto components | <br><br><br><br><br>OP/OE is not less than 12 percent.<br>OP/OE is not less than 8.5 percent. |
| Taxpayers that advance intragroup loans to *wholly owned nonresident subsidiaries*, when the loan is sourced in Indian rupees (excluding loans by enterprises engaged in lending or borrowing in the normal course of business). | Interest rate equal is not less than base rate of State Bank of India (SBI) on 30 June of the relevant previous year plus:<br>1. 150 basis points [when loan amount does not exceed INR 50 crores (approx. USD 8 million)]; or<br>2. 300 basis points [when loan amount exceeds INR 50 crores]. |
| Taxpayers that provide explicit corporate guarantee to *wholly owned nonresident subsidiary*. | |
| • When amount of guarantee does not exceed INR 100 crores (approx. USD 16 million). | Commission or fee at a rate of not less than 2 percent per annum on the amount guaranteed. |
| • When amount of guarantee exceeds INR 100 crores and the credit rating of the borrowing AE done by an agency registered with SEBI is of adequate to highest safety. | Commission or fee at a rate of not less than 1.75 percent per annum on the amount guaranteed. It has been clarified that the term corporate guarantee excludes performance guarantees and comfort letters. |
| * Operating profit margin on operating expense | |

Other important changes in the final rules relating to procedural and other related aspects are briefly set out below:

- To exercise the safe harbor option, taxpayers must furnish Form 3CEFA on or before the due date for filing their income tax return for the relevant year (if the option is exercised for one year) or for the first year (if the option is exercised for more than one year). Taxpayers opting for multiple-year coverage under the safe harbor rules are required to file a statement annually with the tax officer before filing the tax return.
- A validly exercised safe harbor option will remain in force for a period of five years or a period chosen by the taxpayer (in Form 3CEFA), whichever is less, provided certain conditions are met. A new provision allows taxpayers to opt out of the safe harbor regime by filing a declaration to that effect.
- The final rules incorporate time limits during which the tax authorities can challenge the validity of the safe harbor option exercised by a taxpayer. In practice, taxpayers will have certainty regarding the acceptability of their eligibility for the safe harbor within a period of six to seven months from the date of filing Form 3CEFA: two months for the tax officer to refer the matter to the transfer pricing officer (TPO), two months for the TPO to issue an order, 15 days for the taxpayer to file objections with the commissioner if eligibility is not accepted by the TPO, and two months for the commissioner to issue an order. This is a significant variation from the draft rules, under which the time limits were open-ended. The introduction of a mechanism enabling taxpayers to object before the commissioner if the TPO does not accept eligibility is a welcome measure.
- Under specified circumstances, the tax officer can seek subsequent review of the taxpayers' eligibility for the safe harbor rules by again referring the matter to the TPO.

## Comments

After consideration of the recommendations made by various industry federations and other stakeholders, various changes have been made to the safe harbor rules that indicate a positive attitude by the government. The removal of upper limits for eligibility to opt in to the safe harbor rules will provide an opportunity for taxpayers at large to avail themselves of the rules. The application of the rules for five years (rather than two years as in the draft rules) is another positive development. However, numerous issues remain unaddressed; the most significant are set out below:

- The mark-up percentages prescribed in the rules may not meet taxpayers' expectations (based on industry average margin trends and prevalent commercial rates), and they may reduce the expected benefits. This may be the case specifically for KPO and contract R&D activities. Also, the margin provided for the auto components industry, which has been going through a challenging phase, seems high.
- The safe harbour interest rate for loans would range from 11 to 13 percent (applying the SBI base rate on 30 June 2013), which is on the high side. Further, use of the SBI base rate instead of internationally acceptable LIBOR for foreign-currency-denominated loan transaction is a contentious issue. Because several rulings by the Income tax Appellate Tribunals have accepted the lower percentage of mark-up or interest to be at arm's length, the rates specified in the rules may not find favor with taxpayers. Finally, the rules cover only loans/guarantee provided by taxpayers to/for wholly owned subsidiaries, and rupee-sourced loans, and thus have limited applicability.
- The rules require taxpayers opting into the safe harbor rules to comply with detailed documentation requirements, thus undermining the key benefit of a reduced compliance burden. Once a certain mark-up for a specified service is acceptable to the tax authorities, maintaining detailed documentation thereafter only increases an avoidable burden on taxpayers.
- The rules prescribe different margins for software development, ITeS, KPO, and contract R&D services. A noteworthy aspect is that only service providers bearing insignificant risk are eligible to opt in to the rules. The factors mentioned for the identification of taxpayers with "insignificant risk," include performance of economically significant functions, provision of funds/capital, and ownership of intangibles by a foreign principal Distinction in mark-up percentage between various services, presumably on the basis of the high-end vs. low-end nature of the activities, could lead to an increase number of disputes regarding the characterization of taxpayers.

It is expected that during audits and APA/MAP negotiations, the revenue authorities would not consider the safe harbor margins as a reference point. A circular from the CBDT clarifying that safe harbor rates should be strictly applied only to taxpayers who opt for the rules and should not be generically extended to other taxpayers (who do not opt for the rules) would provide comfort to such taxpayers. While provision to this effect is contained in the rules, a circular explaining the rationale and making it binding on all officers would go a long way toward building taxpayer confidence.

There is no doubt that the release of the long-awaited safe harbour rules is a step in the right direction, and that the certainty and administrative convenience offered by the rules would be an additional incentive that will increase the attractiveness of India as an investment jurisdiction. The rules are expected to help overcome potential transfer pricing litigation and to create an amicable tax environment.

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## China's SAT Issues Annual APA Report

China's State Administration of Taxation (SAT) on 13 August 2013 released the 2012 Advance Pricing Arrangement (APA) Annual Report. This fourth release of the annual report follows the same pattern as the previous three versions, with comprehensive statistics and some interesting insights into how the SAT approaches the APA application process.

The report shows that in 2012 the SAT concluded three unilateral and nine bilateral APAs – a new record for bilateral APAs in one year. The three unilateral and nine bilateral APAs include renewals for one unilateral and six bilateral APAs. These statistics clearly reveal the emphasis on bilateral APAs by both taxpayers and the SAT.

## SAT's views

The preface to the report was once again prepared by SAT Deputy Commissioner Wang Li The tax authorities once again took the opportunity to provide brief comments on issues the SAT dealt with in the last 12 months, and which they are likely to deal with in the future.

A paragraph about how China continued to use concepts that are referred to as "pro-developing country" is of particular interest. These concepts – location costs savings, market premiums, and marketing intangibles – have been pursued across the full range of tax authority activities, from tax audits to APA negotiations. There has been an emphasis on accumulating practical experience and gaining international support for these concepts within organizations like the United Nations and the OECD.

The SAT has frequently emphasized these concepts, particularly since the release of the China Country Practice Chapter of the UN Transfer Pricing Manual for Developing Countries, which addresses these topics at length. These concepts represent an area of disagreement between the SAT and other tax authorities, although some bilateral APAs involving them were successfully concluded in 2012.

The preface also refers to the SAT's shift in focus from undertaking reactive audits to proactively influencing taxpayers to transform their compliance behavior. This has partly been achieved through the APA process and by constantly urging taxpayers to change pricing or planning strategies, ensuring that they increase or maintain their profit levels in China. The SAT can now monitor this through their comprehensive indicator system, which enables the authorities to evaluate and monitor taxpayer profit levels by industry, region, and year.

Taxpayers should welcome the publication of these comments, because the growing level of transparency provides companies a better understanding of the SAT's current and future expectations.

## Running the APA program

In the 2011 report, the SAT pointed out that its APA and Mutual Agreement Process (MAP) team, which included only six members, was understaffed. The tax authorities have started to deal with this situation, and the team expanded to eight members during the last year. The team members are divided according to their individual expertise into three teams, each covering Japan and South Korea, the rest of Asia Pacific (including the United States and Canada), and Europe.

For the first time, the SAT has also published details regarding how it will prioritize APA requests, providing a user guide for taxpayers who are interested in an APA. Factors to consider include:

- The overarching principle is "first come, first served";
- The quality of the request submission from a document and technical perspective:
- Whether the industry or region involved in the APA request merits priority attention; and
- Whether the bilateral APA partner country intends to accept the application.

While many of these points were already known, it is useful to see this list. The SAT has pointed out that technical analyses incorporating location-specific advantage concepts, or other innovative applications of transfer pricing methods will be given priority. This gives the SAT more opportunities to raise these concepts with overseas tax authorities.

## Analysis of detailed statistics

The 2012 report includes the same categories of statistics as the 2011 report, providing some insights as to how the APA program is being run.

APAs signed per year – China signed three unilateral APAs (one of which was a renewal) and nine bilateral APAs in 2012 (six of which were renewals). The number of unilateral APAs concluded decreased significantly, and a record number of bilateral APAs were concluded.

Since the inception of China's APA program, the total number of APAs concluded in any one year has never exceeded the 14 concluded in the first year. This fact reflects the limited resources available to the SAT, as well as the increase in the number of bilateral APAs, which will always be more time consuming than unilateral APAs. But if staff numbers continue to increase, the number of APAs concluded should also increase.

APAs by phase – The report provides a detailed overview of APAs by their current status. In recent years, there has been a growing number of APAs at the "preacceptance" and "accepted" phases – at the end of 2012, there were 121 APA applications at these two phases. The preacceptance phase includes APA applications for which the taxpayer has sent the in-charge authorities a proposal/letter of intent, or has had a prefiling meeting, but the authority has not yet accepted the APA application. These applications could still be declined for a number of reasons, although most of them will be accepted once they are processed. Once the APA applications are accepted by the authority they will move into the accepted phase, where they are subject to a detailed examination and evaluation – scarce resources to do the examination is one of the reasons for delays between the preacceptance and accepted phases.

The following table from the APA report shows the detailed statistics:

| Phases | | Unilateral | Bilateral | Total |
|---|---|---|---|---|
| Preacceptance | Proposal / letter of intent | 6 | 40 | 46 |
| | Prefiling meeting | 0 | 33 | 33 |
| | Subtotal | 6 | 73 | 79 |
| Accepted applications | Examination and evaluation | 3 | 27 | 30 |
| | Negotiation | 2 | 10 | 12 |
| | Subtotal | 5 | 37 | 42 |
| Concluded APAs | *Agreed but not signed* | 4 | 2 | 6 |
| | Executed and monitored | 15 | 19 | 34 |
| | Expired | 41 | 10 | 51 |
| | Subtotal | 60 | 31 | 91 |
| Total | | 71 | 141 | 212 |

What is not obvious from looking at only the 2012 figures is that the total number of unilateral APA applications is nearly unchanged from 2011, but there are now 73 preacceptance bilateral APAs requests, compared to 51 in 2011. Likewise, there are now 37 accepted applications, compared to 27 in 2011. These statistics show large increases in the number of bilateral APAs moving through the process, clearly reflecting the trend towards prioritizing bilateral APAs.

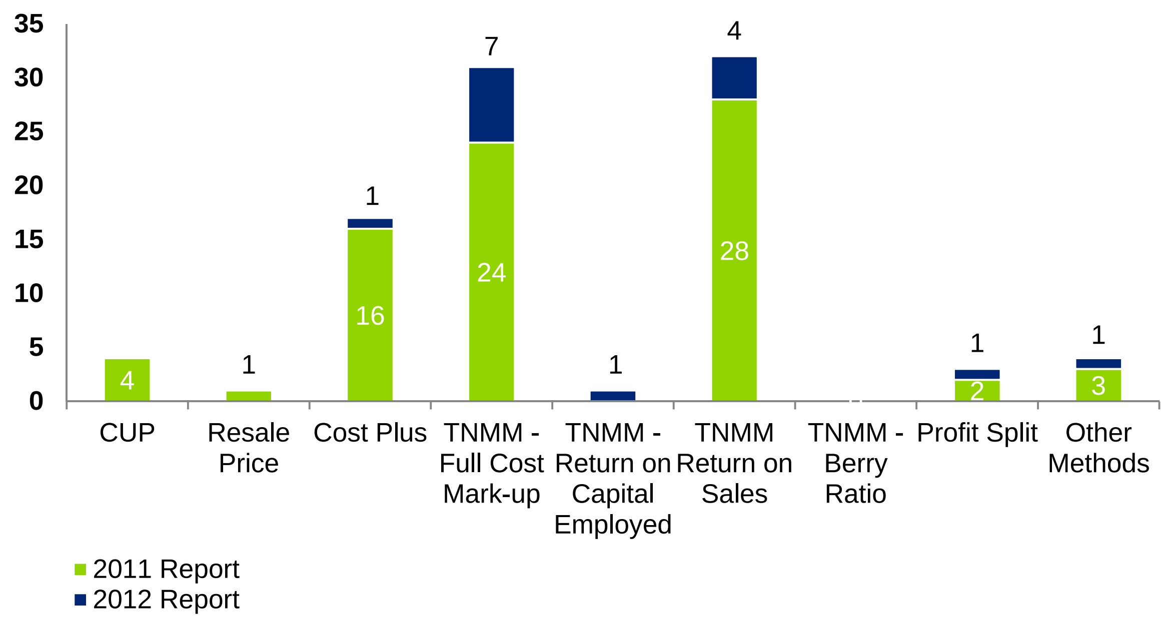
APAs by processing time – The SAT generally aims to complete the evaluation and negotiation of a unilateral APA within 12 months, and within 24 months for a bilateral APA. The following table shows the time taken to complete the APAs concluded in 2012, along with the statistics for APAs from 2005 to 2012 included in brackets.

| Type of APA | From application to signing | | | | |
|---|---|---|---|---|---|
| | < 1 year | 1-2 years | 2-3 years | >3 years | Total |
| Unilateral | 2<br>(30) | 1<br>(25) | 0<br>(1) | 0<br>(0) | 3<br>(56) |
| Bilateral | 6<br>(17) | 0<br>(4) | 1<br>(5) | 2<br>(3) | 9<br>(20) |

Based on the number of renewed bilateral APAs, it seems reasonable to conclude that the six concluded in less than one year were the renewed APAs, while the others took over two years.

The target time frames for concluding APA applications are ambitious, and it not surprising that the SAT is having trouble meeting its targets. As the number of bilateral APA applications continues to grow, it is likely that APAs will be concluded outside the time frames, particularly if complex issues regarding location-specific advantages are part of the applications.

APAs by transfer pricing method – Previous APA reports have shown that the transactional net margin method (TNMM) is the most popular method, with the cost plus method the only other frequently used method. The 2012 report shows that the TNMM was used for 12 transactions, with the cost plus, profit split, and "other method" categories each being used once. The split of the selected methods in 2012 and over time is shown below.




While it is encouraging to see methods other than the TNMM being used, they still represent a very small number compared to the total number of APAs.

## Observations

The SAT's APA report is now an anticipated annual update on the progress of the Chinese APA program, and is truly welcomed by both taxpayers and advisors. These statistics and general commentary continue to give practitioners and taxpayers useful insights into how they should approach APAs, and how the SAT may deal with applications.

The fact that continuing references to concepts such as location-specific advantages and Chinese marketing intangibles form part of the APA work program is not surprising, given the policy approach being taken by the tax authorities. However, the introduction of these concepts is not going to help taxpayers conclude APAs in a timelier manner. To the contrary, because many of these concepts are disputed by overseas tax authorities, the time to conclude APAs is likely to increase.

The time frame for concluding APAs is certainly affected by the limited resources available to the SAT; however, it is reassuring to see that renewals seem to be processed very quickly. Given the increasing number of APA applications, and the continued increase in transfer pricing disputes, the SAT has grown its team, although there is still a need for additional staff. We continue to see efforts from the tax authorities to train transfer pricing specialists, and are optimistic that more dedicated APA resources will be available in the future. This will help to clear the growing backlog of APA applications, making the APA program more attractive to taxpayers.

Overall, the 2012 report demonstrates the continued development of the Chinese APA program, and the SAT's exemplary efforts to provide transparency. Unfortunately, the SAT's limited resources may still restrict the growth of the program. Taxpayers with particularly complex or difficult circumstances may be dissuaded from pursuing APA opportunities until the backlog of APAs can be reduced. However, it is good to see that bilateral APAs have been concluded when China wishes to address location-specific advantages or marketing intangibles.

Following the issuance of the China country guide for the UN Transfer Pricing Manual, the SAT's position on pro-developing country concepts is very clear, and APAs that help China assert these principles will clearly be given some priority. But it is not clear how overseas tax authorities will react.

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## French Parliament Approves New Transfer Pricing Documentation Obligations

France's National Assembly on September 18 approved legislation that would enact additional transfer pricing documentation requirements. The Senate then approved the bill on October 8 with no modifications, and the law is now expected to become final in the coming weeks.

Following discussions initiated in July 2013, the National Assembly – the lower of two chambers of the French parliament – voted to approve new transfer pricing documentation requirements, under Article 11 bis D of the new draft law on fraud and tax evasion. French affiliates of multinational groups will need to self-assess and prepare an additional set of transfer pricing documentation, to be submitted on an annual basis within six months following the filing of their annual tax return. The law is expected to apply to all fiscal years ending on or after December 31, 2013.

### Background

The National Assembly approved a new transfer pricing documentation obligation in a draft law aimed at fighting fraud and tax evasion. Some transfer pricing documentation elements will now need to be prepared and submitted – not only in cases of tax audits, as under the current provisions of Article L 13 AA of the French Tax Procedure Code, but on a proactive and annual basis.

The bill passed by the National Assembly is expected to become law by the end of October, upon approval by the French Senate (the upper chamber of the French parliament), which voted on October 8, with the National Assembly then voting on final confirmation. Because the current version of Article 11 bis D is in line with the Senate's prior recommendations, the terms of the new obligation may be considered final. Furthermore, it is anticipated that fiscal years ending on or after December 31, 2013, will be subject to this new requirement.

### New requirements

New Article 11 bis D applies to any legal entity (including permanent establishments in France) that meet the criteria specified under the current Article L 13 AA, which governs the transfer pricing documentation requirements. Specifically, one of the following conditions must be met:

- The entity has a gross annual turnover or gross assets equal to or exceeding €400 million;
- The entity owns, directly or indirectly, at least 50 percent of companies that meet the €400 million criteria;
- More than 50 percent of the entity's capital or voting rights are owned, directly or indirectly, by French or foreign entities that meet the €400 million criteria;
- The entity benefits from France's worldwide tax consolidation regime; or
- The entity is in a consolidated tax group in France and at least one group company meets any of the above criteria.

Under Article 11 bis D, taxpayers must submit this new transfer pricing documentation within six months following the submission of their annual tax return. For example, a taxpayer with a fiscal year-end of December 31, 2013, will have to submit the documentation no later than November 2014, six months after the May deadline for filing the income tax return.

The new documentation required should include the following elements:

- General information concerning the group and group-related companies:
  - A general description of all business activity, including any changes during the last fiscal year;
  - A list of the taxpayer's principal intangible assets, including patents, brands, commercial names, and know-how, related to the French entity; and
  - A general description of the group's transfer pricing policy and any changes that occurred during the last fiscal year.
- Specific information regarding the French affiliate:
  - A description of the taxpayer's entire activity, including any changes during the last fiscal year;
  - A summary of transactions with other related parties, classified by transaction type and by amount, when the aggregated amount per transaction type exceeds €100 000; and
  - A presentation of the method(s) used to determine the taxpayer's transfer pricing policy (following the arm's length principle), including the main method used and any changes that occurred during the last fiscal year.

Comments

This new transfer pricing disclosure requirement does not replace the transfer pricing documentation that the French tax administration requests during the course of tax audits (under the provisions of article L13 AA) and which encompasses a larger set of information and analysis. Rather, the new disclosure requirement should be considered a new and recurring affirmative obligation for French affiliates of multinational groups.

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## Meeting with Indian Competent Authority Reassures Tax Advisers

More than 100 CFOs and other heads of industry heard from Indian Competent Authority Akhilesh Ranjan and Commissioner of Advance Pricing Agreements Kamlesh Varshney at a September 13 forum in New Delhi organized by Taxsutra and knowledge partner Deloitte.

Ranjan said India must maintain the integrity of its tax base and get its fair share of global revenue, on which tax must be paid when value is added. However, he emphasized that although there are bound to be disputes because of differing interpretations of law, India's tax authorities are ready to engage in a dialogue with taxpayers to minimize or prevent litigation.

The message was clear and simple: India is different but not difficult; there are no instant answers, but the tax authorities are open to constructive conversations with taxpayers. One of the key points from Ranjan's discussion with industry leaders was that discussions have already taken place with the U.S. and U.K. competent authorities, and progress on bilateral APAs and approximately 200 outstanding mutual agreement procedures (MAPs) with the United States should now move more rapidly. Ranjan said he expects to meet with the U.S. competent authority four to six times over the next year.

The government also will look into the inaccessibility of bilateral APAs for some taxpayers in the absence of a corresponding adjustment to article 9(2) in some of India's income tax treaties (for example, with France, Germany, Singapore, and South Korea).

Ranjan also noted that new safe harbor rules were expected soon [the finals rules were released on September 19, a few days after the forum; [see related article in this issue]. He said the safe harbor margins are not arm's-length price margins and therefore are not binding for MAP or APA assessment processes. The Central Bureau of Direct Taxes may issue a clarification to that effect if necessary, he said.
URL: http://newsletters.usdbriefs.com/2013/Tax/ALS/131014_1.html

Also, guidance provided for contract research and development service centers with insignificant risk (Circular 6/2013 of June 29) can also apply for the purpose of an APA.

India strongly supports the OECD's base erosion and profit-shifting project and looks forward to its successful and rational completion, Ranjan said.

Varshney informed attendees that the APA team has undertaken a number of steps to build taxpayer confidence. Despite the large number of applications (146), the APA team ensures that each applicant is heard and that site visits are undertaken at the taxpayers' convenience. He also noted that while there is no specific ''firewall'' provision in India's APA structure, the APA team respects the sensitive nature of certain information, which is kept in the personal custody of APA team members. Varshney said taxpayers also can file APA applications to determine permanent establishment attribution.

The APA team strives to complete APA negotiations in a timely manner but must gather data through site visits and economic analyses before an agreement can be drafted, Varshney said. That work has been completed in several cases, but it will be some time before the first APA is signed because it must first be cleared by the Central Bureau of Direct Taxes and vetted by the Ministry of Law and Justice.

The APA process and new safe harbor rules are welcomed by taxpayers, as are the APA team's transparent approach and positive interactions. It is recommended that the APA team clearly understand the business realities of the taxpayer. The approach taken by the transfer pricing officers and the draft safe harbor rules should not be the starting point or the guiding factor during the APA process. The Revenue Department also should consider making APAs retroactive. Further, companies should be allowed to opt for a safe harbor at the beginning of the year, which would help lessen the onerous transfer pricing documentation requirements.

The take-away from the forum is that tax authorities and taxpayers must build trust by moving from a confrontational approach to a collaborative approach.

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## Italian Supreme Court Rules on Domestic Transfer Pricing

Italy's Supreme Court recently ruled that the country's transfer pricing rules must be applied to domestic intragroup transactions, even though the rules do mention those transactions, and have been applied only to transactions between Italian and foreign related entities.

The Supreme Court addressed the issue of domestic transfer pricing in decision n. 17955 of 24 July 2013, ruling that the transfer prices of intercompany transactions between enterprises resident in Italy for tax purposes must comply with "…the principle set forth in art. 9 of Presidential Decree n. 917/1986, the value of which is general and not only for accounting purposes and which requires making reference to market value for the evaluation of the tax value of proceeds and other revenues…"

The Supreme Court judges deemed "adequate" the arguments put forward by the Italian tax authorities and reversed the Regional Tax Court of Lombardy's ruling in favor of the taxpayer. The Court concluded that the rules regarding international transfer pricing, as set forth in art. 110, 7 of Italy's Consolidated Income Tax Code, could be applied also to domestic transactions. Under Article 110/7, prices relating to intercompany transactions entered into by an Italian resident entity with a nonresident company for tax purposes must be at arm's length,.

The Supreme Court judges challenged the taxpayer's a presumed anti-economic behavior, which in their opinion was motivated expressly to obtain a reduction in the tax burden by means of transfer prices not in line with the market, notwithstanding the fact that the transfer pricing regime cannot be directly applied within the Italian territory, because transfer pricing "*represents an anti-abuse regulation, not only with roots in the EU's principles on the abuse of Law, but also immanent to other sectors of Tax Law…" (Supreme Court decision 22023/06*).

By referring to the general antiabuse rule, the Supreme Court judges *de facto* expanded the scope of article 110/7 beyond its meaning to encompass intercompany transactions entered into between Italian companies, thus making it legitimate for the tax authorities to challenge "domestic" intercompany prices and to adjust them, if deemed not at arm's length, provided the underlying operation resulted in a tax saving.

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## Peru Grants Extension for 2012 Transfer Pricing Reporting Obligations

Peru's tax authorities on October 5 published a resolution extending the deadline for filing the fiscal year 2012 transfer pricing annual return and the transfer pricing study, originally due in October, to November 2013.

Resolution No. 175-2013-SUNAT, published in Peru's official gazette on May 30, 2013, provided safe harbors for the transfer pricing documentation requirements introduced in Peru in 2006, and introduced amendments to fit the content within the scope of the new documentation rules provided by the income tax law from June 30, 2012.

The new documentation requirements affected the reporting obligations of fiscal year 2012 for documentation that is due in 2013, when for the first time the technical transfer pricing study would be included as an appendix of the transfer pricing information return.

To allow taxpayers to comply with the fiscal year 2012 obligation, the return deadline was originally extended from June 10-24, 2013, to October 9-23, 2013.

Given the approaching deadline, and to facilitate compliance, a new resolution published in Peru's official gazette on October 5, 2013 (Resolution No. 301-2013-SUNAT) provides additional guidance on the completion of the reporting process and extends the deadline for compliance. The new deadline for the FY 2012 return is November 11-25.

### New guidance

The transfer pricing information return, and the technical transfer pricing study when applicable, must be reported using version 1.3 of Virtual Form No. 3560.

In line with this requirement, the tax authorities are instructing that once the form is filled out, it must be saved in compact discs or USB memory drives for purposes of submission. The technical transfer pricing study must be submitted in Word converted into PDF.

If the template generated by the form is equal to or larger than 3 MB, it must be submitted online through SUNAT Virtual. Otherwise, it must be submitted physically at any of the authorized locations administered by the tax authorities.

Comments

Considering the Peruvian tax authorities' increased emphasis on transfer pricing obligations and the likelihood of having tax inspections focus on transfer pricing matters in the short term, affected taxpayers should take advantage of the extension granted and review carefully the information to be reported in compliance with the new rules before the deadline.


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## Costa Rica Enacts Transfer Pricing Regime

For the first time in its history, Costa Rica has enacted a transfer pricing regime. Executive Decree No. 37898-H, which had been signed by President Laura Chinchilla Miranda on July 4, was published in the official gazette on September 13, the effective date of the new regulations.

The decree includes 10 articles that spell out the new transfer pricing rules. Article 1 defines and establishes the arm's length principle, requiring taxpayers that enter into transactions with related parties to determine their income, costs, and deductions taking into consideration the prices that would have been used by unrelated parties in comparable transactions.

If the taxpayer's transfer prices do not match those that would have been agreed to by unrelated parties, Article 2 authorizes the tax authorities to make any necessary adjustments.

Article 4 provides a definition of related parties, a key concept because only transactions between related parties are subject to the transfer pricing analysis.

Taking into account all events and circumstances, as well as the features of each transaction, external and internal comparable will be established, and the most appropriate method for assessing the transactions will be chosen.

Article 6 lists the methods that may be used to determine transfer prices:

- The comparable uncontrolled price method;
- The cost plus method;
- The resale price method;
- The profit split method; and
- The transactional net margin method.

The interquartile range may be used to determine arm's length prices; if a transaction price falls outside the range, the price will not be considered to be arm's length and the tax authorities may adjust the price to the median.

Taxpayers engaged in domestic or cross-border transactions with related parties, or those defined as large taxpayers, must file an annual informative return. Moreover, taxpayers subject to the transfer pricing rules must maintain documentation to support their pricing of related-party transactions; Article 9 lists the specific items of documentation required.

The decree provides for the introduction of advance pricing agreements, whereby taxpayers and the tax authorities may agree to the price of related-party transactions in advance. APAs would be valid for a three-year period.


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## Deloitte Submits Comments on OECD's Revised Discussion Draft on Transfer Pricing of Intangibles

Deloitte has submitted comments on the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles issued on 30 July 2013. Below is a summary of Deloitte's comments; the full submission may be viewed on Deloitte.com.

Considerable work has been done since the release of the original draft for discussion purposes in June 2012 and following the OECD's Public Meeting in November 2012. This process, allowing for early comment and debate, has been of great benefit in establishing clearer guidance on the transfer pricing of intangibles, and we look forward to OECD Working Party 6 continuing this practice in future projects.

It is important to consider the revised discussion draft against the broader backdrop of the OECD's Base Erosion and Profit Shifting (BEPS) project (in particular, Action 8, ensuring that transfer pricing outcomes in respect of intangibles are in line with value creation). The revised discussion draft goes much further toward helping taxpayers and tax authorities understand the key factors in determining the appropriate pricing of intangibles. In particular, the emphasis placed on application of the arm's length principle and the approach set out in Chapters I-III of the OECD's transfer pricing guidelines is an essential tenet for transfer pricing to be applied on a reciprocal basis in cross-border situations.

### Essential for guidance to be principled

It is important for businesses and tax authorities, and the coherence of the international tax system, for there to be a principled approach to transfer pricing, including in relation to intangibles. The alternative, whereby a lack of clearly stated principle leads to different tax authorities taking different approaches, will lead to an increased number of disputes, resulting in more mutual agreement procedure (MAP) cases when MAP is available, or more double taxation. In addition, if a lack of principle leads different taxpayers to different approaches, this seems to us to be unhelpful in light of one of the aims of the BEPS project to provide a level playing field. In either scenario, the outcomes could be detrimental to the promotion of international trade and economic growth.

The revised discussion draft sets out to be a principled expansion of the existing transfer pricing guidelines, and we agree that this is the right approach. There are several important reasons why the OECD should insist on providing a principled expansion of existing guidelines. Chief among them are:

- There is no need to depart from the arm's length principle (such as in increased use of recharacterization) because with careful analysis and clear guidance in Chapter VI of the transfer pricing guidelines (for the application of the principles contained in Chapters I-III) the result will be appropriate in the context of concerns about Base Erosion and Profit Shifting and can be applied to all taxpayers in all countries equally; and
- The revised guidance will also apply to current treaties that have adopted Article 9, and maximizes the potential for this revised guidance to be of benefit in application of any national legislation of countries that follow the OECD transfer pricing guidelines.

### Recharacterization

In light of the above, one area of concern that remains would be any departure from the principles in paragraphs 1.64 et seq of Chapter I of the Transfer Pricing Guidelines in relation to recharacterization.

There are two fundamental issues with recharacterization. The first is that the question always arises: "Recharacterize to what?" The second is that it is unlikely that two tax authorities will share the same view that the transaction should be recharacterized (or what the nature of the recharacterization should be), leading to potential for dispute and MAP. The issues of concern to tax authorities can be dealt with in a more principled and ordered manner by application of the revised guidance (in particular the sections on the return due to the legal owner) and, where more than one party has contributed to the creation of value in the intangible, by the appropriate use of the profit split methodology.

### Clarity and simplicity

The revised discussion draft provides useful and principled guidance on many areas of the transfer pricing aspects of intangibles. Some paragraphs remain that would benefit from wording amendments for clarification, and just a small number of points that should be revised. In addition, because of the consultative way the discussion draft has developed, it is important to take a fresh look at the structure of the chapter before it is released for inclusion in the transfer pricing guidelines. This is necessary to ensure that taxpayers and tax authorities are presented with clear statements of the process and principles to be followed.

That said, the ultimate outcome from the application of final guidance – if it were to be changed in this way – would be the same as that from this draft. In other words, to the extent that revision is still required, it is to ensure the route taken to an arm's length answer is commensurate with the arm's length standard and the behavior of third parties, rather than the answer itself. In other cases the guidance could be simpler and clearer to achieve the same end. This second paper, save for section D3 – "Arm's length pricing when valuation is highly uncertain at the time of the transaction," which is still to be considered by Working Party 6 – is welcomed as another big step forward in the process.

The instruction to consider "cause" for payment separately from "valuation" of the payment is particularly welcome. In practice, many transfer pricing disputes stem from a failure to consider "causality" for payment before embarking on an argument about "valuation" of the payment. However, it would have been preferable to have seen the revised discussion draft written afresh, informed by the first paper and by subsequent commentary and debate, rather than an editing of the original discussion draft. There is an opportunity to introduce structure and process into the guidance that would enhance its value in practical use.

There are areas in which significant improvements in clarity, brevity, and usefulness of the guidelines could be achieved by following the arm's length principle and by asking the question: what happens between unrelated parties? In many cases, this is because the draft does not yet have appropriate accuracy in the language it uses. For example:

- The revised discussion draft struggles to avoid using the categorization of "intangible property" and "intangible assets," which is the arm's length approach in commerce. However, the paper creates afresh these two categories; dealing with intangibles that are owned and can be used, licensed, or sold (which are intangible property) and intangibles that can be used, but are not owned, and can be transferred only associated with another good, service or intangible (which are intangible assets). Using these clear and well-understood definitions follows the arm's length principle and would simplify drafting of the remaining guidance. It would also make the guidance much clearer for taxpayers and tax authorities to follow without losing anything of what the paper is trying to achieve.
- The revised discussion draft deals with cases where the owner of intangible property, such as a patent, has little substance and the activities that lead to the creation, commercialization, and defense of the intangible property are performed by others in the group. The guidance can be misread as suggesting that the income (the royalty or license received as turnover) generated by the intangible should be recognized in the hands of those providing the intangible with value and not the intangible property owner. That is a non-arm's length answer, amounting to recharacterization of the transaction. The revised discussion draft could achieve the same result within the current guidelines and the arm's length principle by recognizing that in this example there are two transactions (intangible property license and services (including R&D services) provided) that both need to be considered to achieve the correct result. The intangible property owner is the party who has a legal monopoly through the patent and is the only party who can charge/receive a royalty. However, the correct pricing of the R&D and other activity would, in these circumstances, mean that the final profit realized by the intangible property owner is small, commensurate with its limited functions, assets, and risks. The return for bare legal ownership will be commensurate with a risk-adjusted finance return, and at arm's length, considerably less than the return for human activity awarded to other entities. At paragraph 144, which uses the illustration of having access to a software platform under a license that shortens the development time of a new and different software platform, the revised discussion draft could be misread as departing from the arm's length principle. The arm's length approach will lead to a different solution to that currently indicated.
- Undefined phrases, such as "intangible related return" (paragraph 65) remove clarity from the guidance and should be avoided. Simple, plain guidance based on arm's length behavior is required.

## Valuation

It is very positive that the paper endorses the use of any pricing method, including valuation techniques if traditional methods are unhelpful, that would be appropriate to the facts and circumstances of the particular transaction.

It would strengthen the guidance significantly to include a requirement to show why, in cases where an alternative method is used, the traditional methods are not applicable and also to show that the method chosen has value as "evidence". That approach supports the exclusion of valuation processes such as "rule of thumb" (paragraph 162). In addition, if a transfer pricing case comes to litigation the courts will take into account evidence of arm's length behavior. It also provides a safeguard against the correct application of a recognized technique that provides an improbable valuation because the technique is not appropriate to the circumstances of the transaction.

The material included in relation to the application of the discounted cash-flow method is insufficient and inappropriate. Its inclusion might be taken to indicate approval of, or preference for, this tool, disregarding the importance in the choice and prioritization of methods (paragraphs 2.1 to 2.11 of the transfer pricing guidelines, endorsed by paragraph 149 of the revised discussion draft). It should be removed from the guidance because the alternative approach to avoid the issue raised in this paragraph is to include a similar level of guidance for all other potentially applicable methodologies.

### Location savings and group synergies

The new paragraphs for Chapters I – III introduced to deal with location savings and group synergies are welcome. These are well-reasoned, principle-based and need little, if any, adaptation. The continued inclusion of examples in the revised discussion draft is very helpful. However, some of the examples are repetitive and add little or no value, and some deletions may be appropriate. In other cases, the lack of examples showing the point of adjustment/no adjustment decreases their usefulness and amendments should be made accordingly.

### Timetable

The timetable for production of the final version of the new Chapter VI on special considerations for intangibles, for inclusion in the transfer pricing guidelines, is extremely tight. Ideally, the process would include a redrafting based on comments and discussions, with time for a further consultation. The goal of final guidance by September 2014, as set out in Action 8 of the BEPS Action Plan, makes this a challenge. However, the guidance on intangibles will be used by taxpayers and tax authorities (including those in developing countries that follow OECD principles) for many years, and ensuring that it is complete, clear, useful, and accurate will be extremely important in minimizing disputes, use of tax authority resources, double taxation, and cases requiring resolution under MAP. It is in the interests of both tax authorities and taxpayers that the OECD should strive for high quality guidance in this area, irrespective of timetables.

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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.