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Global Transfer Pricing

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## IRS Releases Proposed Updates to Competent Authority and Advance Pricing Agreement Revenue Procedures

The Internal Revenue Service on November 22 released two notices on proposed updates to its guidance for requesting competent authority assistance under the mutual agreement procedure article of U.S. tax treaties and the advance pricing agreement process.

Notice 2013-78 on MAP requests for competent authority relief would supersede current Rev. Proc. 2006-54, and Notice 2013-79 on APAs would supersede Rev. Proc. 2006-9. The IRS has requested comments on the proposed updates by March 10, 2014.

While the proposed updates are currently in draft form, most are expected to be finalized as drafted; thus, taxpayers should plan to comply with them in the near future. A summary of the salient proposed changes is provided below.

### Competent Authority

Assistance for Taxpayer-Initiated Transfer Pricing Adjustments – The IRS proposes to allow requests for assistance arising from taxpayer-initiated transfer pricing adjustments. In the past, the IRS has generally not accepted such cases, on the basis that double taxation was not the result of government action as predicated in the MAP article of the relevant tax treaties. The taxpayer must submit a prefiling memorandum (see below) prior to filing its request for assistance.
However, the IRS reserves the right to deny requests for assistance if the taxpayer-initiated positions evince after-the-fact tax planning or fiscal evasion, or are otherwise inconsistent with sound tax administration. This is a welcome addition, given the IRS's historical policy position regarding taxpayer-initiated adjustments.

Informal Consultations – The IRS will provide oral, informal advice to taxpayers, whether or not in the course of the MAP process, on general matters concerning MAP issues, including whether a MAP issue may exist. Any such informal advice is advisory and is not binding on the IRS. In practice, informal consultations have always been available; however, the proposed rules would make such consultations explicitly available.

Notification of Foreign Tax Authorities via Exchange of Information – The IRS may notify foreign competent authorities of MAP cases that could arise out of anticipated U.S.-initiated adjustments, under applicable exchange of information provisions in U.S. tax treaties. Such notification may relieve the taxpayer of its obligation to notify the foreign competent authority. In those cases, the U.S. competent authority will also notify the affected taxpayers.

Prefiling Procedures and Memoranda – In the interest of making the MAP process effective and efficient, the IRS invites, and in some cases requires, the taxpayer to meet with the U.S. competent authority in a prefiling conference, and/or to submit a prefiling memorandum prior to filing the MAP request. A prefiling memorandum must be submitted if the MAP issues will involve, or could reasonably be expected to involve any of the following:

1. A foreign-initiated adjustment in which the total adjustments exceed $10 million for all MAP years combined;
2. A taxpayer-initiated position;
3. The license or other transfer of intangibles in connection with, or the development of intangibles under, an intangible development arrangement;
4. Any arrangement that qualifies as a global trading arrangement;
5. Unincorporated branches, passthrough entities, hybrid entities, or entities disregarded for U.S. tax purposes;
6. A request for discretionary limitation on benefits relief; or
7. Other circumstances in which the taxpayer believes a MAP issue has arisen outside the context of an examination, such as in cases involving withholding taxes or guidance issued by a foreign tax authority.

In the case of a non-U.S.-initiated adjustment, the memorandum should explain the factual and legal basis of the adjustment, and describe any administrative, legal, or other procedural steps undertaken in the applicable treaty country and any communications with the foreign competent authority regarding the action.

Historically, it has not been common practice to have prefiling conferences in MAP cases. The requirements in the draft notice would render prefiling conferences much more prevalent, and the time required for such conferences will need to be factored in when considering the deadline established in the relevant tax treaty to submit requests for MAP.

Scope of Requests for Assistance – Under the proposed guidance, the IRS may seek to initiate a MAP case in the absence of a MAP request, or it may require that the scope of a MAP case be expanded. Examples of such an expansion include adding treaty countries or MAP issues to the scope of the MAP case, and extending the MAP case to include open tax years that have not yet been adjusted (commonly referred to as accelerated competent authority (ACAP)). The acknowledgement that a MAP request may need to cover more than two countries is a welcome addition, reflecting the reality of how many taxpayers do business.

Updated Format for Requests for Assistance – The request for assistance should take the form of a cover letter with the following categories of information:

- Identifying information and summary of issues and proceedings;
- MAP issue(s);
- Assistance requested and required statements; and
- Attachments.

The proposed changes considerably expand the scope of information that must be submitted.

Requirement to Provide Same Information to Both Tax Authorities – Under the proposed rules, a MAP request filed with the IRS must include a copy of any request filed by the taxpayer or a member of the controlled group with a foreign competent authority seeking assistance for the same MAP issue. The MAP request must also include a written explanation of the nature of any such related request, including any material differences between the MAP request filed with the IRS and the request filed with the foreign competent authority. In addition, the taxpayer must provide both the U.S. and the foreign competent authority any information or documents requested by or submitted to either competent authority (including translations). In practice, the requirement that taxpayers must provide both the U.S. and the foreign competent authority the same information has always been observed; however, the draft notice explicitly incorporates it into official guidance.

Notification of Receipt – The IRS will notify the taxpayer in writing that it has received the MAP request and that the correct user fee has been paid (if applicable). The letter will also provide the name and contact information of the Advance

Pricing and Mutual Agreement (APMA) team leader, the Treaty Assistance and Interpretation Team (TAIT) analyst, or the members of the combined APMA-TAIT team to which the request has been assigned. In addition, the letter will also state (1) that the request is complete and that the MAP process will proceed, together with any administrative or procedural steps the taxpayer must take pertaining to the MAP request; (2) that the request is provisionally accepted but that the MAP process will not proceed until specified deficiencies in the request have been addressed; or (3) that the request is rejected and the circumstances, if any, under which the request might be accepted.

Arbitration Procedures – The proposed guidance includes procedural issues associated with mandatory arbitration provisions contained in the MAP articles of some U.S. tax treaties. Those provisions require the competent authorities to refer certain MAP cases to mandatory arbitration in the event they are unable to negotiate a mutual agreement within a prescribed time period after the "commencement date." The IRS generally takes the position that the commencement date occurs when it has received a complete MAP request as described in the updated revenue procedure. The U.S. competent authority will notify the U.S. taxpayer when the commencement date is established.

Terms of MAP Repatriation – The IRS will determine the terms of MAP secondary or conforming adjustments on a case-by-case basis, taking into account both the principles set forth in Rev. Proc. 99-32 and its authority under the MAP article of the pertinent tax treaty. The proposed guidelines specifically state that the IRS may agree with the foreign competent authority that it is appropriate to eliminate or modify the interest requirement described in section 4.01(2) of Rev. Proc. 99-32.

## APAs

Scope of the Proposed APA – To facilitate efficient resolution of transfer pricing matters, the IRS may request a taxpayer to expand the scope of the proposed APA to include coverable issues relevant to the proposed covered issues when a comprehensive resolution of coverable issues would further the interests of sound tax administration. The IRS may also condition its acceptance of an APA request upon the taxpayer's agreement to include such other issues among the covered issues.

Statute Extensions – The proposed guidelines contain explicit requirements concerning the execution of consent agreement(s) as necessary to extend the period of limitations for assessment of tax for each proposed APA year and for each proposed APA rollback year. The IRS will instruct the taxpayer as to the type of consent to execute (general or restricted), and the duration of the extension for each proposed APA year and each proposed APA rollback year.

Prefiling Conferences/Memoranda – In the interest of making the APA process effective and efficient, the IRS invites, and in some cases requires, the taxpayer to participate in a prefiling conference or submit a memorandum prior to filing the APA request. A prefiling memorandum should be of a length and content appropriate to the size and complexity of the covered issue(s) and must be filed if:

1. The taxpayer wishes to file a unilateral APA request to cover an issue that is eligible for coverage by a bilateral or multilateral APA;
2. The taxpayer seeks permission to file an abbreviated APA request; or
3. The covered issue(s) proposed by the taxpayer will, or could reasonably be expected to, involve any of the following:
    a. The license or other transfer of intangibles in connection with, or the development of intangibles under, an intangible development arrangement;
    b. Any arrangement that qualifies as a global trading arrangement; or
    c. Unincorporated branches, passthrough entities, hybrid entities, or entities disregarded for U.S. tax purposes.

Due Date for Filing Requests – For bilateral or multilateral APA request, the IRS would require a complete request to be filed no later than the earlier of (i) the return due date for the first proposed APA year (retaining the current dollar file rule), and (ii) within 60 days after the bilateral or multilateral APA request regarding the same proposed covered issue(s) and APA years has been filed with a foreign competent authority. Historically, the United States has had significantly later APA filing deadlines than other treaty partners; this provision has likely been added because in some current cases the U.S. APA request has been filed more than 20 months after the request had been filed with the other tax authority.

Requirement to Provide Same Information to Both Tax Authorities – Under the proposed guidance, the IRS would require the taxpayer to provide to all relevant tax authorities any responses, information, documents, or analyses that it provides to one of the authorities, whether such responses, information, documents, or analyses are provided in response to a request from a competent authority or are submitted voluntarily by the taxpayer in support of its APA request. In the interest of minimizing administrative burdens, the IRS would work with the taxpayer during the APA process to find efficient procedures for disseminating responses, information, documents, or analyses to the tax authorities, such as using indexes to catalogue information, documents, or analyses the taxpayer will make available to the tax authorities upon request. As in the MAP cases, the requirement that taxpayers must provide both the U.S. and the foreign tax authority the same information has always been observed in practice; the proposed guidelines merely incorporate it explicitly in official guidance.

Taxpayer Permitted to Comment on IRS Draft Position Paper – The proposed guidelines contain a specific requirement that the IRS provide to the taxpayer a memorandum describing the substance of the IRS's views on the proposed APA. The memorandum will be of a length, content, and format appropriate to the size and complexity of the proposed covered issue(s) and method(s) and other relevant facts and circumstances surrounding the case. The taxpayer will be allowed to respond to the memorandum by a deadline set by the IRS.

Updated Format for APA Requests – The draft notice proposes that APA requests take the form of a cover letter with the following headings:

- Executive summary;
- Administrative information;
- Proposed covered issue(s);
- Proposed covered method(s);
- Proposed APA terms and conditions, including a draft of the proposed APA; and
- Exhibits.

The proposed information requirements, as well as the format for submission, are much more explicit than under the existing revenue procedure, and should assist the APMA team in terms of reviewing the APA request.

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## Mexican Tax Reform Brings Transfer Pricing Uncertainty to Maquiladoras

The Mexican Senate on 30 October 2013 approved a broad tax reform package that President Enrique Peña Nieto had presented to Congress on 8 September. The package contains a series of initiatives to modify current laws and enact new legislation. As of the date of this article, the legislation was awaiting the president's signature and publication in the official gazette to complete the enactment process. Once formally enacted into law, the new provisions will enter into effect on 1 January 2014.

This article focuses on the provisions that are most relevant to the operation of maquiladoras, particularly in the area of transfer pricing, and provides recommendations on evaluating the different alternatives that may reduce the economic impact of the tax reform.

### Maquiladora Regime

In 2003,[1] Mexico included in its Income Tax law an exemption for the determination of a permanent establishment (PE) in Mexico for foreign residents that maintained an economic and legal relationship with a Mexican maquiladora that habitually

[1] In 2000 and 2001, Mexico's Hacienda and the U.S. Treasury Department entered into a Mutual Agreement to determine the guidelines for the taxation of maquiladoras and to establish a permanent establishment exemption for maquila operations until Mexico enacted domestic rules granting protection to such a PE.

processed merchandise using machinery and equipment provided directly or indirectly by the foreign resident, provided that the foreign resident was resident of a country with which Mexico had entered into a double taxation treaty, and that the maquiladora fulfilled the obligations under article 216-Bis (which included the transfer pricing self-assessment option).

The definition of a maquila operation traditionally has been set forth in several presidential decrees that have governed the operation of maquiladoras for customs purposes since the 1960s; however, in 2006 the Ministry of Economy decided to merge all export-oriented promotion programs into a single program denominated the “IMMEX decree.”

According to the tax authorities, they have detected many corporate restructures whose sole objective is to gain access to the tax benefits granted to maquiladoras. As a result, the IMMEX decree was modified in late 2010 to include a new, tighter definition of maquila operations for tax and PE protection purposes that entered into effect as of January 1, 2011.

Under the approved tax reform, the tax authorities have incorporated in the Income Tax Law a new definition of maquila to better control which taxpayers can access the maquila regime’s income tax benefits.

According to the tax authorities, the new maquila definition is motivated by the following facts:

1. The maquila definition and its requirements have undergone many changes through the years. When first established, the maquiladora regime contemplated an obligation to export 100 percent of a maquiladora’s manufactured products, whereas today the requirement is to export US$500,000, or a minimum of 10 percent of production. As a result, companies that do not fall within the scope of the program as originally designed are enjoying the regime’s tax benefits.
2. The modification follows an OECD recommendation to eliminate special tax regimes. The maquila regime establishes a preferential treatment that complicates the administration of tax laws and facilitates base erosion and tax evasion, according to the tax authorities.

## Transfer pricing obligations for maquiladoras

The PE exemption incorporated into the new Mexican Income Tax Law continues to include the obligation for maquiladoras to satisfy the arm’s length principle in the provision of maquila services.[2]

Under the new obligations, a maquiladora that is required to obtain PE protection for its nonresident party would have available only two options:

1. Applying the safe harbor. This option requires the maquiladora to report as the minimum taxable profit the larger of two computations based on:
    a. 6.9 percent of the value of operating assets, including the maquiladora’s and the nonresident’s assets (machinery, equipment, buildings, inventories, etc.), and
    b. 6.5 percent of operating expenses incurred by the maquiladora in the provision of its services, including expenses paid by the nonresident on behalf of the maquiladora.
2. Entering into an advance pricing agreement (APA) with the Mexican tax authorities.

It’s important to mention that the tax reform eliminates two options that have been available since 2003 for maquiladoras to comply with the arm’s length principle:

1. A transfer pricing study using the adjustments and methodologies allowed[3] in the Mexican Income Tax Law and the pricing must include an amount equivalent to 1 percent of the M&E net value of the principal.
2. A transfer pricing study using the transactional operating profit margin method in which the profitability of the principal’s M&E property is considered.

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[2] This new obligations are set forth in article 182 of the new Mexican Income Tax Law, substituting the current Article 216-Bis.

[3] The Mexican Income Tax Law allows the following transfer pricing methods based on the OECD transfer pricing guidelines: the comparable uncontrolled price method; the resale price method; the cost plus method; the profit split method; the residual profit split method; and the transactional operating profit margin method.

Both of these options were largely used by maquiladoras when the safe harbor resulted in profit margins that were not appropriate to a maquiladora's specific circumstances or consistent with the economic performance of its industry sector.

The approved reform basically throws the maquiladora industry back to the limited options available before 2003.

Maquiladoras that elect to apply the safe harbor option would continue to file a notice of election during the three-month period after the end of the fiscal year.

In addition, the tax reform incorporates into the Law the obligation that all maquiladoras, notwithstanding their transfer pricing election, must file an informative return (DIEMSE from its Spanish acronym) no later than June of the following year.

### What is next for Maquiladoras?

Derived from the approved legislation and the most likely elimination of the tax exemption, it is expected that Maquiladoras will increase their tax provisions starting in 2014.

Maquiladoras may perform a series of evaluations in order to try to reduce the exposure to a serious economic impact from the tax reform:

Evaluate if their operations in fact create a PE in Mexico – In general terms, almost by default, it is assumed that Maquiladoras create a PE in Mexico and as a result they need to request relief via the Mexican PE exemption by satisfying the rules previously described.

A Maquiladora that is left out of the new maquila definition due to the new stricter requirements should be interested in evaluating if in fact its current structure creates a PE exemption under Mexican Income Tax Law or under the Double Taxation treaties signed by Mexico.

Perform a feasibility analysis to define requesting an APA option – The safe harbor rates are taken from the Mutual Agreement negotiated by Mexico's Hacienda and the U.S. Treasury almost 15 years ago, rendering those rates outdated for the realities of the current worldwide economic order. Not surprisingly, in many cases the safe harbor option may present inconsistent results, particularly when a maquiladora is asset intensive (that is, it has a high value of M&E and inventory or owns land and buildings). Other maquiladoras in this situation operate in industries that have been affected by the recent economic recession in their home countries.

There is a very particular and important difference between the safe harbor and a transfer pricing method: whereas the safe harbor obligates the maquiladora to report a minimum taxable income, the transfer pricing methods (including the APA) determine and test the price of the manufacturing services that is consistent with comparable arm's length transactions.

Effective in 2014, the APA alternative (either unilateral or bilateral) for maquiladoras that are deemed to create a PE for their nonresident principal will provide an opportunity for the tax authorities to considers their specific circumstances (significant idle assets, operating in industries experiencing structural changes or reporting low returns, or companies significantly affected by the limitation of deduction of tax exempted fringe benefits), thus mitigating the risks associated with a tax result that would undermine their competitive position.

It is not clear whether the SAT will use the same methods to negotiate APAs with maquiladoras as it did during the 2000-2002 campaign. Most likely, it will require market-based compensation for the M&E owned by the nonresident principal, as opposite to the 1 percent return required under the current rules. An important consideration is whether inventories of raw materials and finished products should be included in the return required to maquiladoras, since a return on inventories for maquiladora is excluded in the current regulations. Moreover, according to domestic law, the conservation of inventories property of a nonresident with the sole purpose of their processing by a different entity does not constitute a PE.[4]

A request for an APA must be filed before 31 December 2014 and under the terms of the Federal Tax Code a unilateral APA may cover up to five years (the filing fiscal year, the preceding fiscal year, and up to three subsequent years). The term for a bilateral APA may be longer, and is up to the competent authorities to determine.

[4] Article 3, Numeral II of the Income Tax Law.

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## China Issues Guidance on MAP

China's State Administration of Taxation (SAT) issued guidance on 24 September 2013 (Bulletin 56) that aims to make the mutual agreement procedure (MAP) under China's tax treaties and tax arrangements more efficient, transparent and user-friendly. Bulletin 56 supersedes previous guidance on the MAP (Circular 115).

The measures in Bulletin 56 are broader in scope than those in Circular 115: Circular 115 is applicable only to MAP requests initiated by Chinese residents or nationals, whereas Bulletin 56 also covers MAP requests initiated by the competent authorities of treaty partners and by the SAT itself. In general, application of the MAP is restricted to matters within the scope of a tax treaty. However, Bulletin 56 provides that the MAP can be invoked to resolve issues outside the scope of a treaty if such issues will result in double taxation or have a significant impact on the interests of one or both of the treaty partners, provided the competent authorities of the treaty partners agree to the application of MAP. Bulletin 56 also provides that the Chinese tax authorities should keep information provided during the MAP process confidential.

Bulletin 56 sets out clear and systematic procedures for a Chinese resident or national to request MAP assistance. A Chinese tax resident or national that has a dispute with the tax authorities of a treaty partner can submit a MAP request to the SAT through the provincial tax authorities if the person believes that the measures taken by the treaty partner have led or will lead to the levying of tax that is not in accordance with the treaty provisions.

A Chinese resident can request a MAP in the following cases:

- When there is a dispute about the tax residence status of the taxpayer, particularly in cases of dual residence;
- When there is a dispute about the determination of the existence of a permanent establishment or the attribution of profits to a permanent establishment;
- When there is a dispute about the taxability or exemption of income or capital;
- When the nondiscrimination article in a tax treaty is violated;
- When there is a dispute about the interpretation or applicability of treaty provisions that cannot otherwise be resolved; or
- When there are other issues that may cause double taxation.

A Chinese national who is not a resident can request a MAP when the person believes the nondiscrimination article of a treaty has been violated by the treaty partner and, therefore, tax discrimination may arise or has arisen.

Bulletin 56 provides guidance for determining which Chinese tax authorities are responsible for accepting a MAP application in various situations. It also sets out the conditions in which the relevant tax authorities should accept a MAP request and provides a clear timeline for the SAT and the relevant tax authorities to handle MAP cases.

If a taxpayer, withholding agent, or other agent provides false information in a MAP request, Bulletin 56 allows the tax authorities to impose penalties in accordance with the Tax Administration and Collection Law and other relevant regulations.

Bulletin 56 specifically states that separate guidance will be issued for MAP requests relating to special tax adjustments, so that cases involving special tax adjustments such as transfer pricing, controlled foreign corporations, or general anti-avoidance issues will be governed by separate guidance.

### Comments

Bulletin 56 provides clarity and certainty on how a Chinese resident or national can initiate the MAP process, and a specific timeline for the SAT and the provincial tax authorities to review and decide whether to accept a MAP request. When an agreement is reached under a MAP that requires the Chinese tax authorities to refund tax, Bulletin 56 also provides a three-month timeline for issuing the refund. These guidelines should make the mutual agreement process more transparent, and bring it in line with international practice. Separate guidance will be issued for the highly anticipated MAP relating to special tax adjustments, especially in relation to commonly encountered transfer pricing disputes.

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## View from Canada: A note of caution on safe harbors?

The Organization for Economic Cooperation and Development (OECD) on 16 May 2013 formally approved the revisions to Section E of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* addressing safe harbors. The revisions represent a significant change from previous commentary by the OECD on the use of safe harbors in tax policy administration. Specifically, Section E no longer concludes that "the use of safe harbours is not recommended." While the OECD remains cautious on the use of safe harbours, the guidance has been revised to acknowledge that a number of countries have adopted safe harbor rules. Further, Section E now contains sample memoranda of understanding (MOUs) that tax administrations may use for specific transactions when negotiating bilateral safe harbors.

One of the key benefits that have enticed some OECD member countries to implement safe harbors is that they provide for a more efficient use of the limited resources available to tax administrators globally. Some tax authorities, including the Canada Revenue Agency (CRA), are adopting risk-based audit selection techniques, consistent with the OECD's Draft Handbook on Transfer Pricing Risk Assessment,[5] showing a global drive toward maximizing the efficient use of resources by tax administrations. As discussed by the OECD, safe harbors allow tax administrators to focus on transactions and taxpayers with higher risk and more complex transactions.

In this light, it is easy to see the appeal of safe harbors as an administrative tool where prolonged audits are commonplace and even seemingly routine transactions can fall under the microscope of tax administrators. However, the authors believe that to appropriately implement safe harbors in the future, it is important for tax administrators to proceed cautiously and reflect on the reasons why safe harbors have been underutilized in the past.

### Deviation from the Arm's Length Principle

As noted by the OECD in revised Section E, safe harbors involve a trade-off between adherence to the arm's length principle and "administrability." This reflects the somewhat paradoxical standpoint of the OECD and most member countries that the arm's length standard must be adhered to, but that negotiated safe harbors may supersede that principle when desired.[6]

As discussed in revised Section E, the safe harbor may result in the most appropriate method of pricing a transaction under the arm's length principle being ignored. Consider, for example, the following scenario: Company X provides low-risk manufacturing services to related nonresident Company Y. Company Y also obtains low-risk manufacturing services from arm's length parties under sufficiently comparable conditions, so that the comparable uncontrolled price (CUP) method could be reliably applied to test the controlled transaction with Company X. Absent a safe harbor, the CUP method would be used, which for illustrative purposes will be assumed to require net cost plus 20 percent. However, if a safe harbor exists allowing for net cost plus 5 percent, Company X could elect to earn a net cost plus mark-up of only 5 percent, even though a reliable CUP indicates net cost plus 20 percent is what would be agreed to at arm's length and taxed in Company X's jurisdiction.

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[5] Released April 30, 2013.

[6] It is interesting to note that the OECD's July 30, 2013, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles also reflects a tendency to deviate from the arm's length principle, as noted by John Henshall and Greg F. Smith in "OECD Guidelines Chapter VI: Initial thoughts on the July 30th paper" (*Transfer Pricing International Journal*, September 2013), "[t]he paper can be read as suggesting that the income generated by the intangible should be recognized in the hands of those providing the intangible with value, and not the IP owner, which would be a very odd (and non-arm's length) answer."

The above hypothetical example shows that the trade-off between compliance with the arm's length principle and administrability may be more than trivial if circumstances are such that the fundamental tenets of the arm's length principle are traded for ease of administration. Furthermore, many tax administrations have a strong preference for the CUP method (when it can be reliably applied). Implementing safe harbors to supplant the determination of the most appropriate method therefore runs contrary to established practices and may lead to profit distortions between various jurisdictions.

### Impact of Other Relevant Intercompany Transactions

Safe harbors also have the effect of pricing one intercompany transaction independent of other relevant intercompany transactions. From a Canadian perspective, while transfer pricing analysis should generally be approached on a transactional basis, as confirmed in the Supreme Court of Canada's October 18, 2012, decision in the *GlaxoSmithKline Inc. v. The Queen* case, other transactions may need to be considered in the context of the economically relevant circumstances.

In *GSK*, the Supreme Court of Canada ruled that "[i]t is only after identifying the circumstances arising from the Licence Agreement that are linked to the Supply Agreement that arm's length comparisons under any of the OECD methods or other methods may be determined."[7] Therefore, proper administration of the arm's length principle involves considering all relevant factors, including other relevant intercompany transactions. If a safe harbor had been used in the company's pricing model, however, it would have served to isolate the supply agreement transactions and dictate a safe harbor return ignoring other relevant considerations such as the license agreement. Consideration of other potentially relevant intercompany transactions is critical when drafting safe harbor MOUs, or unanticipated complications or profit distortions could arise.

### Negotiation Bias

The authors agree with the OECD's analysis that unilateral safe harbors – compared to bilateral or multilateral safe harbors – are more likely to produce non-arm's-length results, double taxation, double nontaxation, or arbitrary results. However, bilateral safe harbors can also give rise to additional challenges. In a bilateral context, two taxing authorities must negotiate the provisions for application of a safe harbor, where factors such as competing interests, relative sophistication of the parties, and bargaining power can lead to inappropriate outcomes.

Consider a hypothetical example of a bilateral safe harbor addressing the provision of routine research and development (R&D) services between Country X and Country Y. When Country X has significantly more routine R&D services being performed for the benefit of foreign related parties compared to the volume of similar services being provided inbound to the country, Country X will have an inherent bias to maximize the return (and therefore the tax revenues) by inflating the safe harbor rate. If Country X is relatively more sophisticated from a transfer pricing perspective, or otherwise able to dominate the safe harbor negotiations, this bias to maximize local tax revenues could result in a safe harbor agreement that is not impartial, and not in the best interest of Country Y. Further, negotiation bias could also lead to a single taxing jurisdiction having different safe harbor rates for the same activity if entering into multiple MOUs.

### Location-Specific Profit Expectations

Using the same safe harbor rate for each member of the MOU in a bilateral agreement may seem equitable. However, country-specific factors that affect investment decisions by multinationals should not be ignored. The decision to invest capital in a particular tax jurisdiction involves considering a multitude of factors, including country-specific factors.

Consider political stability, for example. If jurisdiction X experiences higher socioeconomic risks resulting from political instability or unstable infrastructure (risk of expropriation, power outages, strikes, etc.) relative to jurisdiction Y, with all other things being equal, arm's length parties would expect higher returns in jurisdiction X than in jurisdiction Y, to compensate for the higher risk of investment. Application of a single safe harbor return in this context would be fundamentally flawed.

### Administrative Benefits May Fail to Materialize

One of the conceptual benefits of implementing safe harbors is the potential to reduce the compliance and administrative burden for both taxpayers and tax administrations. However, the presence of a safe harbor will not reduce the need to fully

[7] 2012 SCC 52 at paragraph 60.

consider the functions performed, risks assumed, and capital deployed in the context of the intercompany transaction. Specifically, even properly administered safe harbors would not eliminate the need for a complete functional analysis, and may simply shift the documentation burden from the determination of an arm's length return to supporting whether the transaction qualifies for safe harbor treatment.[8]

It is very difficult in practice to cover all possible fact patterns in the establishment of criteria to qualify for a safe harbor. Consequently, the authors believe tax administrations would still require significant information from taxpayers to assess whether the taxpayer appropriately qualifies for safe harbour treatment (for example, is a low-risk R&D function truly low risk, or is highly valuable intangible property that may be significantly underpriced being created?). Judgement on the part of taxpayers and tax administrators will still be necessary, which will ultimately give rise to the same disputes that occur in the absence of safe harbors.

### Conclusion

The authors agree with the revised Section E of the OECD' s transfer pricing guidelines that tax administrations should carefully weigh the benefits of and concerns regarding safe harbors. Safe harbors represent a potentially useful tool in decreasing the administrative burden on taxpayers and tax administrations. However, it is important that adequate consideration be given to the potential pitfalls associated with safe harbors when entering into MOUs, recognizing that the current administrative burden may simply change in focus rather than decrease. It is the authors' view that implementation of safe harbors should occur only after realistic expectations of the administrative savings are weighed against potential complicating factors, including superseding the most appropriate method, isolating safe harbor transactions from other relevant intercompany transactions, addressing the potential for bias during safe harbor negotiations, and consideration of location-specific factors when setting safe harbor rates.

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## Angola Introduces New Transfer Pricing Rules

The Angolan government on 1 October 2013 published legislation in the Official Gazette that regulates the taxation of large taxpayers, and includes a new transfer pricing regime.

Angola's existing transfer pricing framework is established in the Business Income Tax Code. Article 55 of the BITC empowers the tax authorities to make the necessary adjustments if they conclude that a special relationship between parties has given rise to price deviations in comparison with the conditions normally agreed upon by unrelated parties, a norm recognized as the arm's length principle.

### New Presidential Decree

The new law – Presidential Decree nº 147/213 – contains detailed guidance on the transfer pricing rules applicable to transactions that begin or occur on or after 1 January 2013. The provisions of the decree will be applicable to any commercial transactions (those involving goods, rights, or services) or financial transactions. Article 11 of the law describes the concept of associated enterprises. A "special relation" exists between two entities if one entity has or may have, directly or indirectly, a significant influence in the management of the other entity, namely:

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[8] For example, some taxpayers may be disappointed by the limited relief from the documentation burden that is granted in India's final transfer pricing safe harbor rules, which still require an onerous comprehensive functional and risk analysis and support showing that the taxpayer meets certain safe harbor definitions to be eligible for the safe harbor.

1. When the management of one entity (or their relatives), directly or indirectly, have a participation of no less than 10 percent in the capital or voting rights of the other entity;
2. Entities in which the majority of the members of the corporate bodies of any administrative body, board of directors or supervisors are the same persons or people connected by marriage, other (legal) forms of joint households, or by direct kinship;
3. When the entities have entered into a subordination agreement;
4. When entities are connected through a domain relation, reciprocal participations, parity group or any other with similar legal effect under the Companies' Law;
5. When two or more commercial entities engage in transactions that represent more than 80 percent of the total volume of operations of one of the entities; and
6. When one entity finances the other entity with more than 80 percent of its credit portfolio.

The new rules establish a requirement for the mandatory preparation of a transfer pricing file every fiscal year by "Group A"[9] taxpayers (Article 6 BITC), when the sum of their sales and services rendered exceeds 7,000 million Kwanzas (approximately USD $70 million or €50 million).

The transfer pricing file must be prepared and delivered to the tax authorities within six months after the year end (in Angola, the fiscal year end is December 31, which means taxpayers will have to deliver this file by June 30 of the following year). Although subject to change by the National Tax Director, the file should be structured as follows:

- Summary;
- Macroeconomic environment;
- Presentation of the entity;
- Functional analysis of the entity;
- Identification of related-party operations; and
- Economic analysis of related-party operations.

In order to conduct an economic analysis to test the arm's length principle, Article 13 specifies the use of traditional transfer pricing methods – the comparable uncontrolled price method, the resale minus method, and the cost plus method.

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## Indonesia Introduces Guidance for Tax Auditors – What should taxpayers expect during a transfer pricing audit?

Indonesia's Directorate General of Taxation (DGT) on 24 October 2013 issued Circular Letter No. SE-50/PJ/2013 regarding technical guidelines for audits of taxpayers with special relationships. SE-50 refers to the newly issued regulation PER-22/PJ/2013 on the same subject. SE-50 is effective from 24 October 2013, and officially revokes SE-04/PJ.7/1993.

In conducting a transfer pricing audit, tax auditors must follow three stages: (a) a preparation stage; (b) an implementation stage, and (c) a reporting stage. During the implementation stage, tax auditors will determine the characterization of the taxpayer, select the transfer pricing method, and finally apply the principle of fairness and common business practice (known as the arm's length principle).

[9] Group A taxpayers include state companies, "Sociedade Anónima" structures (roughly equivalent to public limited companies), partnerships limited by shares, other commercial companies, such as "Sociedade Limitadas" (limited liability companies), economic interest groups and civil partnerships adopting a commercial company form whose registered capital exceeds a limit periodically stipulated, credit or insurance institutions and foreign exchange offices, permanent establishments in Angola of nonresident companies, individuals and taxpayers whose average turnover of the last three fiscal years exceeds a periodically stipulated limit.

Although SE-50 is addressed to the heads of tax offices in Indonesia, taxpayers need to understand what can be expected from tax auditors during a transfer pricing audit. The next paragraphs discuss some of the information, documents, and forms tax auditors may consider and focus on during a transfer pricing audit.

### Tax Auditors' Focus in the Preparation Stage

During the preparation stage, tax auditors will carefully examine the taxpayer's documentation in relation to its related-party transactions. Some of the things tax auditors will look for include:

- The significance of related-party transactions proportionate to the taxpayer's sales or net operating profit.
- Related-party transactions in which the counterparties are domiciled in low-tax jurisdictions.
- Special related-party transactions, such as transfers of intangible property, royalty payments, intragroup services, and interest payments.
- Whether the taxpayer's net operating profit is lower than that of other companies within the same industry.
- The significance of other related-party transactions that are not part of the net operating profit, such as interest, gain/loss from asset sales, and foreign exchange gain/loss.
- Related-party transactions that are not in the course of business, such as restructurings and sales of intangible property.
- Taxpayers that are in loss positions for several years.

### Avenues for Tax Auditor in Gathering Information

Besides examining the taxpayer's documentation, the tax auditors could subpoena or conduct a site visit to interview taxpayers' key personnel for further clarification and fact-gathering. If required, the tax auditor may also carry out an exchange of information with foreign tax offices outside Indonesia or with local tax offices in Indonesia to verify any questionable information or documents. Should the tax auditors allege taxpayer engaged in tax avoidance, there will be a change of course of the audit program.

### Average Industrial Performance

The circular letter repeatedly encourages tax auditors to test the taxpayer's performance against average industry performance as one of the factors in considering the taxpayer's transfer pricing profile. How to identify similar industry performance still needs to be determined.

### Increased Scrutiny of Taxpayers' Counterparties

During the transfer pricing audit, the tax auditor would also examine the taxpayer's counterparties in detail. This includes the organizational chart, financial statements, the number of employees, and qualification of the counterparties. Support from the taxpayer's affiliates and proper timing are the keys to satisfy this requirement.

### Selection of Transfer Pricing Method

The circular letter provides a framework for tax auditors in selecting the most appropriate transfer pricing method. The initial step the tax auditor must perform is to identify the availability of comparable data that will be used to test the intercompany transactions (internal and external comparable data). The second step is to consider the facts and circumstances of the transactions in selecting the most appropriate method.

### Internal Comparable Data

The tax auditors must ensure the reliability of the internal comparable data by checking (a) that the internal comparable data does not result from independent transactions that were performed merely to justify that the related-party transactions are at arm's length; (b) that the independent transactions are performed in the normal course of business; and (c) consideration of the five comparability factors.

## External Comparable Data

The circular letter provides that external comparable data could be in the form of market commodity prices, LIBOR, SIBOR, JIBOR, and data obtained from other commercial databases. The tax auditors must consider the five comparability factors in selecting reliable external comparable data.

## Tested Party

Under the circular letter, tax auditors will consider the following factors in selecting a tested party:

- The tested party generally must be the less complex entity (for instance, a party that does not own any unique intangible assets);
- In case the tested party selected is a transaction counterparty located outside Indonesia, the tax auditors must ensure the reliability of the counterparty's data by requesting information from the taxpayer and/or conducting an exchange of information with the competent authority in the country where the counterparty is domiciled.
- If the tax auditors are not convinced that the information regarding the foreign counterparty is reliable and sufficient, the tax auditors would have the option to select either the taxpayer or another affiliated company as the tested party.

## Specified Steps in the Application of Transfer Pricing Methods

The circular letter lays out specific comparability factors that tax auditors must consider for the application of each method, further expanding on the guidance previously provided in the existing Indonesian transfer pricing regulations. The letter provides further guidance and case studies for the application of traditional methods, including more detailed factors to consider when assessing the selection of the most appropriate method, instructions on carrying out reasonably accurate adjustments, and the selection of the most appropriate profit level indicator (PLI).

## Direct and Indirect Approaches in Application of Transfer Pricing Methodology

The circular letter provides a direct approach and indirect approach for the application of each method. The direct approach should be applied in instances when there are no material differences between the independent and third-party transactions, while an indirect approach should be used for transactions with differences for which "reasonably accurate adjustments" may be made to ensure enhanced comparability. The circular letter provides examples of accepted "reasonably accurate adjustments" in the application of each method.

## Multiple-Year Analysis

The circular letter provides that multiple-year data will be used to enhance a comparability analysis, that is, to identify which potential comparable data differ significantly from the tested party. This may lead to the rejection of such potential comparables or the identification of other anomalies. The letter also states that the use of multiple-year data in the comparability analysis does not mean the tax auditors will use the average performance of several years to determine the arm's length price or margin.

## Single Transaction vs. Aggregate Transactional Approach

Further clarification is provided on the application of the aggregate transactional approach. The circular letter provides that transactions may be tested in aggregate if such transactions are closely linked or continuous (for example, long-term contracts for the supply of commodities and services, close link between intangible properties and products, closely linked products, and portfolio products).

## Intragroup Services

The circular letter reiterates the importance of establishing the utilization and economic benefits derived from the receipt of intragroup services. SE-50/PJ/2013 confirms that the burden of proof is on the taxpayer to establish the receipt of services received. This includes an extensive list of evidence to be provided by the taxpayer to prove the utilization and benefits from intragroup services, as well as an extensive list of activities prohibited to be charged to a service recipient (for example, shareholder activities, duplicative services, incidental benefits, and passive association).

SE-50/PJ/2013 emphasizes that a comprehensive review is required on the actual costs incurred in the provision of services, the correlation between costs incurred and services received by the taxpayer, the cost recording method of direct and indirect costs, and the key allocation method applied in determining service charges to the service recipient.

### Intangible Assets

The circular letter specifies the steps to be taken in assessing intangible asset transactions. Particular focus is placed in assessing the taxpayer's contribution to the creation, development, protection, and maintenance of the IP. It also identifies the factors to be considered to determine the value of the intangible asset (level and duration of protection, exclusivity, geography, useful life, right to develop/revise and modify the IP, any closely linked intangibles or service related to the IP, right to sublicense, etc.).

Furthermore, in identifying the use and existence of intangible property, tax auditors will consider the following factors, among others: (a) the level of the taxpayer's profitability compared to the average performance in the industry; (b) the existence of the IP is not determined based on whether or not the IP is recorded in the balance sheet; (c) the existence of the IP is also not determined by whether or not the IP is registered.

### Interest Rate Transactions

The steps that need to be undertaken to assess loan transactions include the following:

- Analyzing the need for the related-party loan. One of the things that auditors will examine is the borrower's ability to pay back the loan interest, by calculating the taxpayer's interest coverage ratio (i.e., EBIT/interest charge).
- Checking that the loan was actually rendered.
- Checking the borrower's debt/equity ratio.
- Checking the arm's length nature of the applied interest rate.

### Primary, Secondary, and Corresponding Adjustments

The circular letter further justifies primary adjustments that may lead to secondary adjustments for the consistent application of the former. If a primary adjustment is made at the net operating level, tax auditors would distribute the adjustment to the related party-transactions that are considered to have the highest risk of tax avoidance.

The circular letter also provides for the possibility of a corresponding adjustment based on the prevailing transfer pricing regulations.

### Reporting Stage and Tax Auditors' Working Paper

Circular Letter SE-50 includes 10 forms presented as guidelines for tax auditors as their working papers to document the information and documents received during the audit. At the end of the examination, the tax auditors will document their findings on the taxpayer's related-party transactions, which will then be used to determine the next course of action.

It is crucial for taxpayers to understand what they can expect during a transfer pricing audit. Taxpayers must plan ahead to prepare transfer pricing documents and information well before the audit starts, especially the information that must be obtained from counterparties in other countries. Failing to plan is planning to fail.

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## An Interview with Aydin Hayri of Deloitte, author of *Transfer Pricing in Action*

Deloitte Tax LLP Principal Aydin Hayri, together with Tax Senior Manager Althea Azeff, recently published Transfer Pricing in Action, a business novel that attempts "to bridge the abstract theory of transfer pricing and its everyday practice." Hayri recently sat down with Arm's Length Standard to discuss the book and transfer pricing trends.

Q: Aydin, your book, *Transfer Pricing in Action*, with Althea Azeff came out earlier this year from Kluwer Law. Can you please tell us what prompted you to write the book and why?

A: The simple answer is that I wanted to share my experiences in the practice of transfer pricing. I find transfer pricing to be an amazingly interesting and dynamic area. With the general acceptance of the "arm's length standard," we have witnessed extensive legislative activity and rulemaking around the world. Transfer pricing concepts that emerged from the interpretation of the arm's length principle, methods, and their applications show surprising uniformity across countries. Another interesting aspect of transfer pricing is that the points of disagreement are arbitrated with reference to economic theory in the areas of industrial organization, financial economics, and corporate finance, which conformed to my background.

Q: Tell us a little about your background in transfer pricing and as an economist.

A: I am a principal with Deloitte's global transfer pricing practice, based in the Washington D.C. National Tax Office. Before joining Deloitte, I was in academia, teaching at Charles University, Prague; the University of Warwick, England; and as a research fellow at Princeton University. Although I hold a Ph.D. from Princeton in economics – a science predicated on the pursuit of individual happiness – it took me a while to figure out that my own calling was in consulting, where you can get instant gratification and feedback on your work. It has been almost 16 years since I made the transition from academia to consulting.

Q: Did you find transfer pricing more rewarding than academia?

A: For me, yes. I've never had a dull moment since I started!

Q: What about new developments since the book was published mid-August 2013?

A: Most of the changes represent a continuing trend by tax administrations to get into the more complicated aspects of transfer pricing. Surprisingly, the underlying principles remain the same. Coming into transfer pricing with an economics background, I never took much comfort in what the legalistic language of local regulations may or may not have prescribed. For me it has always been about the underlying economics, or as some would say, the commercial feasibility of a transfer pricing arrangement. With Althea, we approached our book from this perspective, and also knowing what the emerging trends are. For example, in the book, we introduced the concept of "indicia of beneficial ownership of intangibles." It is a practical way to implement the new OECD draft on intangibles.

Q: What about the increasing OECD focus on control? Did you anticipate that as well?

A: Actually, the origins of our book go to the issue of control. As our understanding and application of the arm's length principle advanced, most of the nuances that were overlooked before became more important. So we began to analyze different shades of risk taking. First we had to deal with significant foreign exchange swings – that has now become almost standard in bilateral APA (advance pricing agreement) discussions. Second came the 2001 recession, followed by the 2008 Great Recession. We had to deal with the risks associated with that. Manufacturing and functional migrations now became the standard staple of business – it is routine for a multinational enterprise to move operations around, reroute its supply chain. All business changes involve upfront pain, followed by potential future gain or cost savings. In my practice, I have been running into the issue of who will take the pain and, of course, the gain. I decided to distill my experiences into an article on the risk allocation and control of risk.

Q: And there was just too much material, and you had to turn it into a book?

A: Well, I became uncomfortable with the abstract tone of the article that was taking shape. I wanted to make the discussion more practical – I began thinking of cases, similar to the examples the OECD included in the draft intangibles chapter. The challenge is that any transfer pricing analysis would rely on the current factual details, history, or course of conduct of the parties, and the availability of benchmarks. If you do not fully develop these three legs of the analysis, something will be amiss. Your conclusions or recommendations would become too simplistic, or abstract. Instead of setting up a case to make a point, I chose to build one detailed case and address many issues along the way.

Q: But would not one extended case study be limited, in terms of the industry and different factual scenarios?

A: You are right. As we got started with the book, we realized that we would be too limited if we stuck to our case only. That is where the business novel format helped. The characters of our fictitious company often reached out to their peers in different industries, who were facing similar issues. Their discussions presented opportunities for us to compare and contrast potentially different fact patterns.

Q: Usually this type of content is presented in a straightforward didactic manner. In *Transfer Pricing in Action*, the content is presented as a story that reads almost like an expanded case study, only with more flare and color. What prompted you to take that route?

A: We felt there is a need to explain transfer pricing from an everyday operational perspective. Existing literature is in the form of textbooks, or anthologies of professional articles, or annotated versions of regulations. This book is meant to fill this void and extend a bridge from the abstract theory of transfer pricing to real-life everyday practice. We wanted to propel the reader from start to finish with "action," hence the title. We went with a genre-bending method, marrying narrative form to straightforward textbook-like prose to bring to life the intricacies that come into play when a group of people interact throughout their company's lifecycle – in this case, from its birth in the United States through expansion abroad.

Q: What would you hope readers will walk away with having read *Transfer Pricing in Action*?

A: If nothing else, I'd want readers to appreciate that tax planning decisions are as real and mission-critical as any other business decisions, and that they require the same level of due diligence as any business investment.

Q: Any predictions as to what's coming in terms of transfer pricing developments for 2014?

A: First of all, there will be more focus on the issue of "control." I could see that a section on "control" will be the standard staple of every transfer pricing study. We will see taxpayers and tax administrations spend more time inquiring about how corporate decisions are made, and how the decision-making processes are documented. If you look at the current debate on base erosion, it is a debate about the primacy of functions versus risks. Large-country tax administrations would like to link risks to functions, while the general trend of global business, with the proliferation of contractual forms, collaboration and outsourcing deals, and financial engineering, presents an opposite trend. We see an increase in the packaging, repackaging, and sharing of business risks.

Q: And how do you expect this tension to be resolved? In the courts, in the local legislatures, or at the multinational level?

A: Well, I believe in the primacy of economic forces. If you think about it, taxation is like any other expense for corporations. In return for domiciling their people and assets in a certain jurisdiction, businesses expect to pay a price, which is the corporate tax. If this price is not right, meaning that there are competing jurisdictions where the price of locating people and assets is lower, corporations will ultimately move there. In a way, tax competition among governments will shape the landscape more than any legislative or policy initiatives.

Q: Does that mean governments' efforts to limit tax planning by multinational corporations may ultimately work against them?

A: I would think so. In economist-speak, relocation of functions and personnel is difficult in the short term. By increasing the tax burden on multinationals, however, the larger OECD countries are effectively forcing the MNEs domiciled in their territories to look elsewhere for the future growth of functions and personnel. In today's world, talent and facilities are increasingly mobile. Business culture is becoming more homogenized, and best practices are spreading faster than ever.

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