Global Transfer Pricing

Arm's Length Standard

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OECD Updates Transfer Pricing Documentation Proposal

During an April 2 webcast, Organization for Economic Cooperation and Development representatives discussed tentative decisions regarding proposed changes to Chapter V of the OECD transfer pricing guidelines on documentation. The tentative decisions reached by Working Party No. 6 at its two-day meeting during the week of March 24 reflect a positive reaction to the numerous comment letters the OECD received in response to the discussion draft issued for comment on January 30, 2014. These tentative changes include reducing the scope of information to be included in the country-by-country template, the most controversial part of the proposed new documentation rules.[1]
URL: http://www.oecd.org/tax/beps-webcasts.htm

Joseph Andrus, who will be replaced in May by Andrew Hickman as head of the Transfer Pricing Unit of the Tax Treaties, Transfer Pricing and Financial Transactions Division within the OECD's Centre for Tax Policy and Administration, discussed the following tentative agreements reached by Working Party No. 6:

- The template will include the following information: revenue, earnings before taxes, cash tax paid, current tax accrual, capital, retained earnings, tangible assets, and number of full time equivalent employees.
- The template will be prepared on an "aggregate" country basis, not a separate entity by separate entity basis. We interpret aggregate to mean a simple adding of the financial information of the entities within a country without eliminating intracountry transactions. However, further clarification is needed on this point.
- Eliminated transactional reporting of interest, royalties, and service charges. This information will only be contained in the local file if relevant.
- Eliminated the requirement to disclose the top 25 highest paid employees.

[1] Action 13 of the OECD's Base Erosion and Profit Sharing Action Plan calls for the development of improved transfer pricing documentation standards, including a country-by-country reporting template. In response to this mandate, the OECD issued a discussion draft containing proposed changes to the OECD documentation rules, including a country-by-country template on January 30. In response to the discussion draft, the OECD received more than 150 comment letters totaling more than 1300 pages.

- A complete list of entities and permanent establishments, with activity codes for each, will be required for each country.
- The rules will provide flexibility on the source of financial information, provided the group uses a consistent approach from year to year. Working Party No. 6 responded to the numerous comments they received stating that companies needed flexibility in providing statutory or financial reporting information because of the wide variety of accounting systems employed by companies.
- Separate the country-by-country template from the master file.
- Provide additional clarification that the master file should be a high-level overview of the company, which will put the company's intercompany transactions in the context of its overall business operations. Many companies were concerned that the list of information contemplated by the January 30 discussion draft could run hundreds of pages. Companies will have to wait for additional guidance to see if they agree that the master file is only a high-level overview.
- Provide flexibility to prepare the master file on either a company-wide or line of business basis.

Working Party No. 6 is scheduled to meet again in May to finalize its recommendation to the Committee on Fiscal Affairs. At that meeting, Working Party No. 6 will try to resolve outstanding questions regarding the process for filing and sharing the master file and country-by-country template. Many companies are concerned that the master file and the county-by-country template may contain confidential information that will likely require the highest level of protection from disclosure. Companies have suggested that this high level of protection may be obtained only by filing the master file and country-by-country template with a company's home country, and making the home country responsible for sharing them with interested countries through government-to-government information exchange agreements. On the webcast, Andrus reassured companies by stating that the country-by-country template is only intended to provide information to governments and not to the general public.

Working Party No. 6 will also consider at the May meeting the language in which the master file and possibly the local file must be prepared, and the requirement for companies to translate the documents into local languages. The January 30 draft stated that the master file is to be prepared in English.

The OECD will hold a public consultation on the proposed documentation rules on May 17. The early release of the tentative agreements is likely an effort on the part of the OECD to better focus the May 17 public consultation on the tentative decisions and outstanding issues.

The tentative agreements are generally in line with the suggestions of commentators, including statements made by the UK and US governments. Some of the tentative decisions will need additional clarification to determine the real impact on companies' compliance burden.

On a related topic, Andrus, in response to an audience question, reiterated that the revisions to Chapter VI of the transfer pricing guidelines on intangibles make clear that group synergies do not create residual income that is not associated with assets, functions, or risks. This comment is similar to other comments that changes in the transfer pricing rules will attribute income to where value is created. These comments appear to reflect the intent of proposed changes to Chapter VI and likely other actions the OECD is considering that are intended to limit so-called one-sided transfer pricing analysis and require companies to support the allocation of income to each segment of the value chain, including the contributions of people, tangible assets, and financial capital.

View the webcast recording or download the PowerPoint presentation.
URL: http://www.oecd.org/tax/beps-webcasts.htm

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Indian APA Program Takes Off

The Indian tax authorities on March 31 signed the first five advance pricing agreements (APAs) in the program's history.

Transfer pricing presents many tax, legal and operational challenges for both taxpayers and tax authorities. To many taxpayers, the uncertainty resulting from the possibility of transfer pricing adjustments – including the potential commitment of management time to successfully defend a transfer pricing examination – goes beyond acceptable business risk.

After India introduced transfer pricing regulations in 2001, the tax authorities' approach in the initial years was fairly reasonable. However, in more recent years the Indian tax authorities have become very aggressive, resulting in a surge of transfer pricing audits, both in terms of the percentage of cases that incur transfer pricing adjustments as well as the quantum of those adjustments.

Appreciating that scenario, the government introduced an APA mechanism in the Finance Act 2012. By March 31, 2013, 146 applications had been received – a substantial number for a first-year APA program. The APA team followed a proactive and intensive methodology to verify the facts in the applications. The negotiation process was carried out in a collaborative manner, with the goal of determining equitable and fair arm's length prices. The process has now culminated in the signing of five agreements on 31 March. This is a great achievement by any standard, given that there are very few instances in which APAs have been concluded in the first year of a program.

The success of India's APA program is driven jointly by the authorities and by taxpayers. Authorities must appreciate the realities facing businesses, and based on that try to reach an equitable solution. On the other hand, taxpayers should be transparent and proactive in sharing information and documents with the tax authorities.

An important lesson from the APA process thus far is that taxpayers must be mindful of a wide range of issues that may come up for discussion during the course of the APA negotiations. Some key issues, for example, relate to site visits conducted by the APA team, interaction with senior employees to understand the functional profile of the taxpayer, the role played by overseas associated enterprises in the transaction under examination, and the level of detail of the information maintained by taxpayers to demonstrate their functional profile. There should be clarity and completeness on these issues to ensure the successful conclusion of an APA.

The success of the APA program will send the right signal to foreign businesses interested in India that the risk of a transfer pricing adjustment may be mitigated through this newly introduced collaborative tool, and may help bridge the current trust deficit between taxpayers and the tax authorities.

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2013 US APA Report Shows Significant Efficiency Gains

The Internal Revenue Service on March 27, 2014 released Announcement 2014-14, the Advance Pricing Agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2013. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a brief summary of recent developments in the APMA Program and a statistical snapshot of the APMA Program's activities during 2013.

The annual report highlights the continued successes of the APMA Program, the most notable of which was the seven-month reduction in the median amount of time to complete an APA. This is a welcome development as companies consider the role of APAs in their transfer pricing risk management strategies in anticipation of changes to the Organization for Economic Cooperation and Development transfer pricing guidelines resulting from the BEPS project.

Statistical highlights of the APA annual report include:

- Increase in Completed APAs – During the 2013 calendar year, APA case closures increased for the second year in a row to a record 145 APAs (39 unilateral, 105 bilateral, and one multilateral), compared with 140 APAs in 2012. Renewal APAs represented 77 of the 145 APAs executed, with 27 unilateral, 49 bilateral, and one multilateral APA renewals. This increase in executed APAs was attributed to the increased resources and processing efficiencies as a result of the combination of the former APA Program with the US Competent Authority.
- Months to Complete APAs – In 2013, the median time to complete a unilateral APA was 27.9 months, and 37.2 months for a bilateral APA. In 2012, the median times to complete unilateral and bilateral APAs were 27.8 months and 44.9 months, respectively. Overall, the median time required to complete the 145 APAs executed in 2013 was approximately seven months shorter than in 2012, a significant and welcome improvement.
- New Cases – The IRS received 111 APA applications (20 unilateral, 89 bilateral, and two multilateral) in 2013, a slight decrease from the 126 APA applications received in 2012. Interestingly, almost 75 percent of the bilateral applications filed in 2013 involved either Japan or Canada, with Korea accounting for approximately 5 percent.
- APA Inventory – The APMA Program had 331 cases in active inventory at the end of 2013 that were either unilateral APAs (51 cases), bilateral APAs (277 cases), or multilateral APAs (3 cases). Given the APMA Program's increased efficiency, the number of cases in active inventory decreased in 2013 from the 391 cases in active inventory at the end of 2012. While the number of pending APAs at the end of 2013 was still higher than in some recent years, the IRS believes the streamlining of the APMA Program's internal processes and implementation of new procedures will result in a continued decrease in pending inventory in future years.
- Term Length of APAs – Of the APAs executed in 2013, 41 percent had a five-year term, while more than half had terms of six years or longer.
- Staffing – The APMA Program is currently comprised of 55 team leaders, 26 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). The team leader groups are organized by country, with each group having responsibility for multiple countries.
- APAs Withdrawn – Nine APAs were withdrawn in 2013 (three unilateral and six bilateral), a slight increase from the six APAs withdrawn during 2012, but equal to the number withdrawn in 2011.
- Inbound v Outbound – Inbound cases continued to account for the majority of the APMA Program's caseload in 2013, with 55 percent of the APAs executed involving foreign multinationals with US subsidiaries. In 2012, inbound cases accounted for approximately 75 percent of the APAs executed.
- APAs Executed by Industry – In 2013, the wholesale/retail trade and manufacturing industries accounted for 41 percent and 35 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (55 percent of cases). Meanwhile, the transportation equipment segment was largest among manufacturers (29 percent of cases).
- Covered Transactions and Transfer Pricing Methods – Similar to 2012, 41 percent of the transactions covered in APAs executed in 2013 involved the sale of tangible goods and 36 percent involved the provision of services. The comparable profits method (CPM) was used to evaluate approximately 77 percent of the transactions involving tangible and intangible property in 2013. Of those transactions, approximately 78 percent used the operating margin as the profit level indicator (PLI). For services transactions, the services cost method was used most frequently (39 percent of cases). In addition, the CPM was used in 36 percent of cases involving service transactions with the Berry ratio representing the most commonly used PLI.
- Adjustment Mechanisms – Almost 70 percent of the transactions covered in APAs executed in 2013 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to tested-party results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2013 executed APAs include: an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year; an adjustment to the closest edge of the range applied to the results over the APA term; an adjustment to the specified point or royalty rate; or an adjustment to the median of the range for a single year.
- Boilerplate and APMA Program Contact Information – The annual report also includes the latest version of the APMA Program's boilerplate APA agreement and a list of primary APMA Program contacts.

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Canadian Court Upholds Canada Revenue Agency's Request for Foreign-Based Information

Canada's Federal Court of Appeal has dismissed Soft-Moc Inc.'s appeal challenging the Canada Revenue Agency's foreign-based information requests for purposes of conducting a transfer pricing audit. The case highlights the accessibility of foreign-based information to the CRA and provides an important reminder to taxpayers regarding the information that may be requested in the context of an international audit.

Background

Soft-Moc made an application for a judicial review of a ruling by Justice James Russell in March 2013 that upheld the CRA's request for foreign-based information relating to a transfer pricing audit. The CRA requested foreign-based information on Soft-Moc's related nonresidents based in the Bahamas under subsection 231.6(2) of the Canadian Income Tax Act. The focus of the CRA's audit was whether the transfer prices for certain services provided by the related nonresidents to Soft-Moc were at arm's length.

Soft-Moc argued that the CRA's request for foreign-based information should be set aside as unreasonable because: (i) it was overly broad in scope; (ii) it required the production of information and documents that were not relevant to the administration or enforcement of the Act; and (iii) it requested information that could not be obtained or provided by Soft-Moc because that information was confidential or proprietary, nonexistent, or otherwise unavailable. In the event the CRA's request was not set aside entirely, Soft-Moc sought to have the CRA's request for foreign-based information varied to delete questions relating to information that could not be obtained or provided by virtue of the information being confidential and proprietary, nonexistent, or otherwise unavailable. The Federal Court dismissed the motion and the Federal Court of Appeal has now upheld that ruling.

Important takeaways

This case further demonstrates the CRA's ability to request foreign-based information that can be critical to the outcome of transfer pricing audits. The type of foreign-based information that can be requested by the CRA is extremely broad based on the definition in the Income Tax Act. Specifically, foreign-based information or documents are defined in subsection 231.6(1) of the Act as "any information or document that is available or located outside Canada and that may be relevant to the administration or enforcement of this Act, including the collection of any amount payable under this Act by any person."

Canadian taxpayers should be aware that foreign-based information is accessible to the CRA and should consider this when setting transfer prices and when faced with an international audit.

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Iceland Introduces New Transfer Pricing Rules

Iceland's Parliament on January 1, 2014, adopted the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations into Iceland's Income Tax Act. Regulations to provide additional guidance on documentation are currently being drafted.

Law no. 142/2013 of December 23, 2013, states that the Icelandic Tax Authorities (*Ríkisskattstjóri – RSK*) are authorized to evaluate and if appropriate adjust the price and/or contractual terms in transactions between associated enterprises if those terms are not comparable to those found in transactions between unrelated enterprises. This rule also applies to prices/contractual terms between enterprises and their permanent establishments. According to the new law, the term "transaction" includes general trade in goods and services, tangible and intangible assets, and any financial contracts.

Enterprises are considered associated if they are:

- Part of a consolidated group, or are under direct or indirect majority ownership or managerial control of two or more enterprises within a consolidation;
- Under majority ownership of one enterprise by another, in the aggregate both directly and indirectly; or
- Directly or indirectly under majority ownership or managerial control of individuals related by marriage, family ties, or financial ties.

The law applies equally to enterprises with only domestic associated enterprises and those with foreign associated enterprises.

Enterprises with turnovers or total assets (at the beginning or the end of the fiscal year) in excess of ISK 1 billion in one fiscal year are obligated to document transactions with associated enterprises from the next fiscal year. Information regarding the nature and extent of those transactions must be preserved for seven years from the end of the relevant fiscal year. Moreover, enterprises must confirm that their documentation is satisfactory in their tax returns. An enterprise must comply with the tax authorities' request for access to information under the documentation obligation no later than 45 days after the request is made by the tax authorities.

Further details on the new law, including guidance on documentation requirements, will be set forth in regulations to be issued by the Minister of Finance and Economic Affairs. A ministerial working group has been established to draft the regulations, which are expected to be issued in June 2014.

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Danish Tribunal Rules on Cash Pooling Arrangement

The Danish National Tax Tribunal recently issued its first decision on cash pooling arrangements and transfer pricing.

The main conclusions from the decision on the current status of cash pools are:

- Deposits in a cash pool are not comparable to bank deposits, and credit risk should be taken into account in setting the arm's length interest rate;
- When no or inadequate transfer pricing documentation is provided, the tax authorities are entitled to make a discretionary assessment, which shifts the burden of proof from the tax authorities to the taxpayer;
- When a cash pool participant has both borrowings and deposits in a cash pool, the interest rate should be calculated on the net position; and
- Services rendered in connection with a cash pool arrangement should be charged as a mark-up on the interest rate rather than on a cost plus basis.

Outline of the case

The case (which remains anonymous at the tribunal level) involved a Danish subsidiary of a Canadian-based multinational company engaged in the production, development, renovation, and maintenance of trains and aircraft. The Danish subsidiary participated in an intragroup cash pool (a zero balancing cash pool, in which all surplus liquidity is physically transferred each day to the cash pool administrator's account) whereby the cash pool operator/top account holder was placed in Switzerland. The cash pooling arrangement was based on a daily overnight interbank rate plus a spread. The spread was -0.5 percent on the Danish subsidiary's deposits and +1.15 percent on loans from the cash pool administrator. All deposits and loans between the group companies and the cash pool administrator were unsecured.

The Danish subsidiary had a cash surplus because of prepayments from customers, which was deposited in the cash pool. In some periods, the Danish subsidiary had placed all its excess liquidity in the cash pool under a short-term binding deposit (up to six months); hence, on occasion the subsidiary needed to borrow from the cash pool for day-to-day cash needs.

The Danish subsidiary had not submitted any transfer pricing documentation as required under section 3B, subsection 5 of the Danish Tax Control Act. This allowed the Danish tax authorities to perform a discretionary assessment of the controlled transactions, including the cash pool transactions.

The Danish tax authorities viewed the deposit as not comparable to a deposit with a bank, because banks are highly creditworthy, whereas the financing company in Switzerland was considered less creditworthy, given that its business consisted of unsecured lending and borrowing.

The group had not prepared a separate credit rating for the cash pool administrator. Accordingly, the Danish tax authorities assessed the cash pool administrator's credit rating to be the same as the group's credit rating, which was Ba2/BB, and thereby disregarded the difference in the spreads on the deposits and loans to and from the cash pool administrator.

The Danish tax authorities took the approach of comparing the cash pool with a credit facility, and accordingly netted the deposits and borrowings by the Danish subsidiary. This resulted in a net deposit for the Danish subsidiary. Consequently, the Danish tax authorities denied deductibility for the interest paid by the Danish subsidiary for its borrowings in the cash pool. The Danish tax authorities denied that they disregarded the transactions undertaken by netting the cash pool transactions, but maintained that they were bundling transactions and adjusting the terms and prices of the existing transactions.

The Danish tax authorities calculated a spread for the deposit based on the Ba2/BB rating of the cash pool administrator. The spread was calculated based on a benchmark analysis and resulted in a spread of 118 bps. Consequently, the interest rate was adjusted to a basic rate plus the spread of 118 bps. Furthermore, the tax authorities assessed a financial service fee of 25 bps payable to the cash pool administrator for administrating the cash pool agreement. The service fee was assessed based on the gross balance of all deposits and loans.

Decision of Danish National Tax Tribunal

The Danish National Tax Tribunal upheld the tax authorities' decision, but lowered the spread from +118 bps to +115 bps on the loan from the cash pool.

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IRS Issues Transfer Pricing Audit Roadmap

The Transfer Pricing Operations (TPO) group of the IRS's Large Business and International (LB&I) division on February 14 released its Transfer Pricing Audit Roadmap to the public. The roadmap provides examination teams, in particular IRS persons involved in the audit of transfer pricing issues, with a broad set of tools and audit techniques to assist with the planning, execution, and resolution of transfer pricing examinations.
URL: http://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf

The roadmap holds the promise of better upfront risk analyses, earlier issue identification, and more targeted information gathering. Better upfront risk analyses may benefit taxpayers and the IRS by identifying and focusing attention on meaningful issues, saving both time and resources that might be wasted looking for, or defending against, adjustments that do not exist. Earlier issue identification may benefit taxpayers and the IRS by allowing for more targeted information gathering, easing compliance with the February 28,, 2014, LB&I Directive on Information Document Requests Enforcement Process (LB&I-04-0201-004) (IDR directive).. There is no doubt that if early risk assessment takes transactions off the table, everyone benefits.

The roadmap demonstrates the IRS's commitment to conducting better, more careful, and stronger transfer pricing examinations. The more taxpayers prepare to demonstrate early in the process the reasonableness of their transfer pricing, the greater the likelihood that they will be able to join with the IRS in avoiding unnecessary, intrusive, and costly transfer pricing audits. Conversely, if a taxpayer cannot demonstrate the reasonableness of its transfer pricing early in the process, the roadmap provides the examination team with clear guidance and helpful tools to move quickly into an in-depth transfer pricing examination.

Another clear benefit the roadmap offers taxpayers is insight into the extent the TPO provides examination teams with the guidance, tools, and resources to identify and apply resources to appropriate transfer pricing examinations, to perform the transfer pricing examinations more efficiently, and to do so in a way that results in adjustments supported strongly by facts, the law, and sound economic analyses. In doing so, it offers taxpayers and the IRS the opportunity to set appropriate expectations for the transfer pricing audit process and for taxpayers to better defend their transfer pricing.

The TPO makes clear, however, that taxpayers will be expected to quickly provide a great deal of information. Absent appropriate prior preparation, it will likely be difficult and costly for taxpayers to produce that information on short notice. For example, examination teams are encouraged to request through an information document request (IDR) an in-depth transfer pricing orientation from the taxpayer. As discussed below, the scope of the information to be discussed during the transfer pricing orientation is extensive. The examination team is encouraged, however, to reassess the scope of the transfer pricing examination following the transfer pricing orientation. This gives the taxpayer an early opportunity to have the examination team remove from the audit plan transactions for which the taxpayer provides compelling arguments for, and strong support of, its transfer pricing.

The roadmap consists of:

- An introduction addressing its key themes;
- A model timeline providing a visual expression of the nine transfer pricing audit stages (TPAS) overlaid on the three quality examination process (QEP) phases;
- A roadmap index listing categories of activities for each phase and links to the sections in the roadmap document containing the guidance and tools for that stage; and
- Links interspersed throughout the roadmap guidance, materials, tools, and resources to assist in the examination.

The roadmap highlights four key themes the audit team should keep in mind during any transfer pricing examination:

- Upfront planning;
- Factual development;
- Reasonable results given the facts and circumstances of the given case; and
- Effective presentation.

The key themes reflect the TPO's desire to provide meaningful guidance for the conduct of transfer pricing examinations. They emphasize upfront planning that includes weeding out transfer pricing issues not worthy of pursuit; factual development, recognizing that "[t]ransfer pricing cases are usually won or lost on the facts";[2] the importance of reaching a reasonable result under the facts and circumstances; and the importance of an effective presentation of the case addressing all relevant facts and the applicable legal and economic principles.

The roadmap identifies nine TPAS, aligned with the IRS's three QEP phases. As might be expected, the suggested timelines for the stages overlap one another, and some of the transfer pricing audit phases carry over from one QEP phase to the next.

The first three stages align generally with the QEP's planning phase. The next three stages align with the QEP's Execution Phase. The final three stages align with the QEP's Resolution Phase.

For each of the transfer pricing audit stages, the roadmap provides detailed steps to be considered, tools that may be used, core audit team members who might be involved in the particular stages, and links to other guidance and materials, including links to materials in the Internal Revenue Manual, IRS forms and instructions, and outside resources for business financial analytics.

Most important, throughout the roadmap the TPO emphasizes the need for judgment in considering the tools and steps used in a particular transfer pricing examination, and in the time and timeline needed and appropriate for the particular transfer pricing examination.

Key Themes

Upfront Planning – The roadmap emphasizes the importance of upfront planning to address the IRS's objectives for its audit pipeline and the time required for proper transfer pricing case development. Realistically, the roadmap recognizes that a transfer pricing audit may take two to three years or more. It addresses the time and complexity of transfer pricing audits by emphasizing the transfer pricing specialist's involvement in the pre-examination planning process, the early consideration of potential transfer pricing matters, early risk assessment, and the development of a transfer pricing audit plan based on that risk assessment. It notes the important role of the transfer pricing specialist in staffing decisions so that resources are assigned appropriate to the level and complexity of the potential transfer pricing issues, and to identify transfer pricing issues that are not worth pursuing. To this end, the roadmap encourages the involvement of transfer pricing specialists at the earliest possible stage, "ideally before the official audit commencement date."

Factual Development – The roadmap recognizes and emphasizes the importance of factual development to the analysis of transfer pricing. When it states that transfer pricing cases are won or lost based on the facts, the TPO makes clear that the audit team should undertake the work necessary to develop a thorough understanding of the relevant functions, assets, and risks, as well as an understanding of the taxpayer's financial information. It emphasizes that the audit team must also have a clear understanding of the taxpayer's value chain, competitive position, and financial results. The TPO recognizes the importance of judgment, common sense, and economic reality, stating that "too good to be true" results might be good candidates for further scrutiny. Reasonable financial results supported by a method that is itself supported by the facts might not be worth further scrutiny. This comports with the TPO's emphasis on early identification of cases worth pursuing.

Reasonable Result Considering The Taxpayer's Facts And Circumstances – The roadmap recognizes and emphasizes the importance of applying sound judgment to facts as developed during the audit. To guide the examination, the roadmap suggests the formulation of working hypotheses during the factual development stage. Most important, it emphasizes that the examination team must maintain "an open mind at all times during the examination" and that the examination team should adjust or discard its working hypotheses based on the facts as they become known during the examination.

The roadmap urges the examination team to document the iterative process of developing the facts and evaluating working hypotheses during the examination as a way to advance the examination and address taxpayer concerns about fishing expeditions and theories in search of facts. This should facilitate discussions between taxpayers and the audit team called for in the LB&I IDR directive. The roadmap gives further recognition to the LB&I IDR directive by stating that documenting the facts provided, the working hypothesis, and the information requested can strengthen the IRS's ability to enforce IDRs

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[2] "Won or lost" may be a poor choice of words as it suggests that a transfer pricing adjustment was otherwise appropriate but that the IRS may or may not have adequately developed the case. A better choice of words might be that usually the determination of whether a transfer pricing adjustment is appropriate depends on a clear understanding of the facts and circumstances.

when necessary. The roadmap also highlights as critical that the audit team address "in full" the taxpayer's analysis, noting that the taxpayer might have the more compelling position. Hopefully, having the examination team give full consideration to the taxpayer's analysis will further discourage fishing expeditions.

Effective presentation of the case – Ultimately, if the examination team is to propose an adjustment, the roadmap emphasizes the importance of presenting the case clearly and persuasively. It urges the examination team to prepare a notice of proposed adjustment (NOPA) that sets forth in a logical way the facts and applicable legal and economic principles so that the conclusion is inevitable. Equally important, the NOPA should address all relevant facts, including those that challenge the IRS's position.

Phases

As mentioned above, the roadmap breaks the Transfer Pricing Audit Stages into three phases that correspond with the IRS's three QEP phases.

Planning Phase – The first three stages align generally with the QEP's planning phase. They consist of the following stages:

- Pre-examination analysis;
- Opening conference, transfer pricing orientation; and
- Preparation of initial risk analysis, exam plan, and key milestones.

Significantly, the latter two planning stages extend well into the QEP execution phase and overlap significantly with the execution phase stages. This emphasizes the TPO's view that the examination team should develop working hypotheses based on the facts obtained to date, and should maintain an open mind to adjust or abandon the working hypotheses for another, or even conclude that the taxpayer's position is indicated by the facts.

The roadmap dedicates a period equivalent to the QEP planning phase to the pre-examination analysis stages. While the roadmap makes clear that these time periods are not decisive, they do indicate the importance the roadmap accords to pre-examination analysis. Over 30 percent of the substantive support provided in the roadmap – seven of 22 pages – address the pre-examination analysis stages, further demonstrating the importance the IRS accords this phase.

The pre-examination analysis is further broken down into three work streams:

- Preliminary assessment;
- Section 6662(e) documentation review; and
- Planning meetings.

During this stage, the transfer pricing specialist is encouraged to work with the international examiner (IE), IE manager, computer audit specialist, team coordinator, economist, and Transfer Pricing Practice (TPP) personnel.

The roadmap suggests a number of steps the transfer pricing specialist should consider during this preliminary assessment. These include:

- Reviewing tax return information regarding intercompany transactions. This would include data from the taxpayer's Forms 5471, 5472, 8858, 8865, 926, uncertain tax positions (UTP), and Schedule M-3. The roadmap recommends using the international information returns (IRR) tool the IRS developed to analyze data from Forms 5471, 5472, 8858, and 8865.
- Reviewing prior audit cycle information.
- Evaluating key taxpayer financial ratios and making comparisons using the IRS's internal Tax Information Gateway (TIG) report and data from S&P's Capital IQ platform.
- Conducting research on the taxpayer's background, history, and core operations using publicly available information, and the company's SEC Form 10-K.
- Preparing the mandatory 6662(e) documentation IDR.
- Preparing an IDR requesting a transfer pricing orientation meeting and a financial statement orientation meeting;
- Working with the IRS computer audit specialist to issue an IDR requesting accounting records including worldwide, geographic, and segmented accounting data and financial statements necessary in a transfer pricing examination;

- Considering what foreign information might be appropriate to request from treaty partners.
- Developing preliminary working hypotheses and transfer pricing risk assessments that take into account:
    - The taxpayer's worldwide effective tax rate and whether its overall tax position is one that would benefit, either on an accounting or cash flow basis, from income shifting;
    - Source of income and tax credit availability benefits;
    - Subpart F; and
    - Collateral adjustments.

The roadmap states that the IE, the economist, and the TPP should coordinate on their initial assessment and working hypothesis. The extent to which the TPP will have the resources to delve deeply into the initial assessment remains to be seen. Likely, they will need to husband their resources for use on cases the examination team believes hold the greatest potential for a transfer pricing adjustment.

The roadmap calls for the economist, IE, and TPP to coordinate in the evaluation of the taxpayer's §6662(e) documentation. They must evaluate carefully the taxpayer's best method selection and the possible applicability of other transfer pricing methods (TPMs). It remains to be seen whether this review produces an examination of the transfer pricing documentation rather than an examination of the taxpayer's intercompany transactions.

To the extent the pre-examination analysis suggests the need for a more formal transfer pricing examination, the roadmap suggests that the examination team consider including in the preliminary planning meeting(s) with the taxpayers a discussion of topics relating to transfer pricing, including, along with the discussions of time frames, key milestones:

- Key taxpayer contacts for transfer pricing matters;
- The types of accounting data and records to be requested, such as segregated profit and loss statements for specific products, product lines, transaction flows, etc.;
- Expectations for a comprehensive transfer pricing orientation;
- The potential need for interviews;
- The IDR process, dealing with delays, and the LB&I IDR Directive; and
- If applicable, IRC §6038A.

Significantly, if a determination is made that an issue regarding transactions involving a treaty partner exists, the examination team should notify relevant Advance Pricing Mutual Agreement Program personnel.

The next TPAS consist of the opening conference and the transfer pricing orientation. The opening conference does not necessarily signal the end of the pre-examination analysis. Rather, it represents the formal start of the examination cycle. Here the roadmap layers a discussion of the following topics onto the general opening conference content and process:

- The transfer pricing compliance process;
- The preliminary scope of the transfer pricing examination and general timelines;
- A review of the roadmap;
- Expectations for a transfer pricing orientation to follow the financial statement orientation;
- Initial observations relevant to the quality of the IRC § 6662(e) documentation;
- Initial thoughts on the need for transfer pricing related interviews; and
- Notification to the taxpayer regarding protecting foreign statutes of limitation.

The roadmap notes that the financial statement orientation should be held within 30 days of the opening conference, and the transfer pricing orientation should occur soon after the financial statement orientation. The roadmap further highlights the depth and breadth of the expected transfer pricing orientation. During the orientation, the IRS will expect the taxpayer to present:

- The taxpayer's background and its history of intercompany transactions;
- All intercompany transactions in the year(s) under exam, including:
    - The taxpayer's rationale for entering into the transactions;
    - The taxpayer's value chain(s) associated with its intangible, services, and/or tangible goods; and
    - Whether the intercompany transaction are associated with the transfer of an income stream, or contribution to the value, of any intangible;

- The functions performed, assets employed, and risks assumed by each controlled party of the respective intercompany transaction;
- How the preparer of the taxpayer's transfer pricing study gained knowledge of each controlled party's functions performed, assets employed, and risks assumed; and
- The transfer pricing methods selected by the taxpayer for significant transactions.

The discussion during the orientation might be expected to address:

- The identity of persons responsible for structuring the transaction from a tax planning perspective;
- The need to request additional documentation, including contracts and agreements not previously requested;
- The process for requesting follow-up meetings and clarifications;
- Whether to request background documentation; and
- A request for the transfer pricing study preparer's supporting documents (interview notes, minutes, etc.).

This suggests strongly that taxpayers must be prepared to conduct the transfer pricing orientation. Moreover, the roadmap states that the IRS team should request that employees involved in planning and structuring the transactions be available and that the personnel responsible for the transfer pricing study be available. The IRS team should emphasize that the transfer pricing orientation should be a comprehensive presentation, not just an overview of the transfer pricing documentation . Moreover, the purpose of the transfer pricing orientation should not be to interview employees; the roadmap provides for that later in the execution phase.

Given the short periods contemplated in the IDR directive, taxpayers may find that they cannot postpone the transfer pricing orientation based simply on resource constraints.

As might be expected, the roadmap recommends that the IRS hold a reassessment meeting to consider those transactions in need of further development, as well as those that should be closed or eliminated from further development. Therefore, it behooves taxpayers to present as compelling a case as possible in support of their transfer pricing at the transfer pricing orientation meeting.

The third set of TPAS in the planning phase – preparation of initial risk analysis, exam plan, and key milestones – overlaps with the opening conference, transfer pricing orientation TPAS, reflecting the iterative nature of the roadmap.

The preparation of initial risk analysis, exam plan, and key milestones stages provide for the preparation of an initial risk assessment and revised audit plan. The roadmap calls for the submission of the risk assessment and modified plan to the international team manager, territory manager, and economist manager for approval. The risk assessment must also be included in the overall audit risk analysis. Significantly, the examination team should provide the approved risk analysis, audit plan, and timeline to the taxpayer.

The roadmap includes a sample timeline, but acknowledges that each audit plan and timeline will depend on the facts and circumstances of the issues and the conduct of the audit. The sample timeline, below, assumes a 24-month examination cycle.

- Last IDR to the taxpayer: 17th month;
- Discuss the government's findings with the taxpayer prior to the issuance of the last NOPA, ascertain the taxpayer's position, and discuss resolution of the last issue with the taxpayer: 18th and 19th month;
- Issue last NOPA to the taxpayer: 20th month;
- Taxpayer response to last NOPA due by: 21st month;
- Issue Revenue Agent Report (RAR)/30-Day Package to the taxpayer: 22nd month;
- Taxpayer's 30-Day Protest due: 23rd month;
- Rebuttal to the taxpayer's protest: 24th month; and
- Closing case: 24th month.

The roadmap makes clear, however, that the risk analysis, audit plan, and timeline will be living documents, updated throughout the audit as facts are developed and issues clarified.

Execution Phase – The second set of three TPAS aligns with the QEP's execution phase. They consist of the following stages:

- Fact finding and additional IDRs / functional analysis;
- Mid-cycle risk assessment,[3]; and
- Issue development and preliminary reports.

The third set of stages also spills into the QEP final phase, the resolution phase. The roadmap estimates that this portion of the examination will take 14 months.

The fact finding stage consists of two parts: additional IDRs and functional analysis. This stage involves exactly what the name implies. During this stage, the IRS should be issuing additional IDRs for factual development, including requests for interviews, plant tours, and site visits. In issuing the IDRs, the TPP specialists are directed to follow the IDR issuance and enforcement procedures set forth in the LB&I directive on IDRs. The tight time frames and enforcement procedures place an even higher premium on a taxpayer's advance preparation.

The roadmap also sets forth specific guidance for conducting the functional analysis. The roadmap makes clear that a functional analysis is a critical aspect of any transfer pricing examination and is best conducted as a team, which may include the international examiner, the team coordinator, the transfer pricing practice, the economist, the engineer, and the field counsel. The team's roles should be clearly understood and the members of the team should engage in robust internal communications and ongoing discussions with the taxpayer to understand the taxpayer's business operations. The roadmap directs the IRS team to perform a comparability and functional analysis, which should include a review and analysis of accounting data, interviews, plant tours, and site visits. In undertaking these steps, the IRS team should:

- Work with the taxpayer to identify key personnel for interviews/site tours;
- Work with the taxpayer to identify plants and sites for tours;
- Work with core IRS team members to prepare for interviews and tours; and
- Consider and evaluate the need for foreign travel.

The roadmap further directs that as part of this stage, the IRS team should continue to meet with the taxpayer to confirm material facts it has developed during the course of the examination, and:

- Provide the draft fact statement and request written confirmation from the taxpayer or an explanation of the differences;
- Consider a full, open discussion/presentation with the taxpayer, which preferably includes the relevant operations personnel, regarding the IRS team's working hypothesis(es) and initial conclusions; and
- Issue additional IDRs as necessary.

Within this stage, the roadmap also instructs the IRS team to reassess the risk analysis and refine the working hypothesis(es) based on new information and the taxpayer's input to:

- Determine which transactions require further analysis;
- Determine which transactions should be eliminated from the work plan;
- Issue additional IDRs as necessary;
- Reevaluate the need for additional internal and outside experts;
- Identify any discrete legal issues; and
- Continue to document, organize, and outline transactions determined to warrant further development and analysis based on information gathered to date.

Throughout the process, the roadmap requires the IRS team to update, correct, and refine the fact statement and begin to develop a general outline of the issue, as well as to coordinate legal issues with field counsel, associate chief counsel

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[3] The third page of the Transfer Pricing Audit Roadmap contains a timeline that presents the mid-cycle risk assessment as a TPAS separate from the fact finding and additional IDRs/ functional analysis stage. However, pages 4 and 21 of the Transfer Pricing Audit Roadmap show the mid-cycle risk assessment as part of the fact finding and additional IDRs, functional analysis TPAS. We have divided the execution Phase into three TPAS.

(international), the TPP, and the International Practice Network. Furthermore, the roadmap emphasizes that continuous communication with the taxpayer and the IRS team throughout the execution phase is critical.

As can be seen from the above, the roadmap requires significant engagement and participation from the taxpayer in the factual development stage. This is an opportunity for the taxpayer to provide its position and to understand the IRS's concerns and issues. The level of engagement expected, however, will demand significant taxpayer resources.

The second stage within this phase, the mid-cycle risk assessment, follows logically from the above. In this stage, the roadmap instructs the IRS team to prepare a mid-cycle risk analysis to reflect an updated risk analysis, as well as an updated timeline and milestones, and to discuss these updates with the taxpayer.

The third stage within the execution phase is issue development, which consists of producing an economic analysis and a preliminary report and findings. The roadmap first requires the IRS team to perform an economic analysis consistent with the working hypothesis. This analysis is performed by the economist in consultation with the international examiner, the TPP, the engineer, and the field counsel, and should include the following:

- A robust analysis of why the taxpayer's method is or is not the best method, and a determination of the best method, if applicable;
- Consideration of the utility of the analysis for resolution purposes; and
- Coordination with the APMA Program on any country-specific considerations.

As part of this process, the economist and other IRS team members should analyze the facts, including the accounting data, to determine the applicable legal analysis, and should continue to issue additional IDRs as necessary. The goal of this analysis should be to complete a draft write-up of the background and facts to be used in the NOPA and in the economist report, assisted by the audit work files and other work papers previously developed. The roadmap directs the IRS team to share this document with the taxpayer and to discuss any inaccuracies and disagreements. The roadmap further states that the draft should be revised as necessary and that the IRS team should aim to achieve an agreed set of facts.

The roadmap directs the economist, in consultation with the international examiner, the engineer, field counsel, and the TPP, to work together to produce a preliminary economist report, which should include a detailed critique of the taxpayer's method and address items such as individual comparables and assumptions . A draft NOPA should also be prepared that includes the draft economist report. Either the draft NOPA or a preliminary analysis of the issue, factual findings, and conclusions should be shared and discussed with the taxpayer. The drafts should be revised, if necessary, based on those discussions. The roadmap notes that this can be an iterative process.

From the above, it can be seen that the roadmap is intended to foster continued dialogue between the IRS team and the taxpayer while the IRS develops its position. While this process will allow the taxpayer to have input into the IRS's final product, it could be very time-consuming and can be successful only if both the IRS and the taxpayer approach the process with open minds.

Resolution Phase – The final three TPAS align with the QEP's resolution phase. They consist of the following stages:

- Pre-NOPA issue presentation;
- Resolution discussions; and
- Final NOPA and case closing.

It is noteworthy how many different people and divisions within the IRS are involved during this process. The core members of the IRS team for the resolution phase include:

- The international examiner;
- The IE's territory manager;
- The economist;
- The engineer;
- The field counsel;
- The associate chief counsel (international) (ACCI), as necessary;
- The TPP; and

- The domestic IRS team (IRS personnel working on non-international sections of the Internal Revenue Code).

This means that there will be a large number of people trying to reach consensus on all the issues facing the IRS. For example, field counsel involvement would likely draw in one or two attorneys (a generalist and a litigation specialist) and two or three of those attorneys' managers.

Similarly, ACCI involvement would draw in one docket attorney, one reviewer, and possibly several ACCI executives (to the extent they were briefed on the issue). TPP involvement in turn would require the involvement of a transfer pricing specialist, the specialist's manager, and possibly several TPP executives (to the extent they were briefed on the issue). Thus, the total number of people working on the resolution phase of any given transfer pricing audit could range from eight to more than 16, depending on how important the IRS considers the case to be. The number of people who may be required to participate in reaching consensus on a resolution may make reaching that consensus difficult. Hence, it is critical for taxpayers to engage with the IRS examination team to find out how the audit is progressing and what all of the various stakeholders within the IRS think about the strengths and weaknesses of the case.

Fortunately, taxpayers theoretically should have plenty of opportunities to find out that information, given that the roadmap emphasizes that continuous communication with the taxpayer throughout the resolution phase is critical. This is reflected in the specific instructions given by the roadmap that the IRS examination agent is required to:

- Work with the taxpayer on resolution;
- Understand the nature of the disagreement between the taxpayer and the IRS (for example, different factual interpretation or different legal interpretation);
- Consider the taxpayer's input for resolution purposes; and
- Consider pre-Appeals resolution opportunities (such as Fast Track) on issues that cannot be resolved at the examination level.

The roadmap sets the 18th or 19th month as the target deadline for Exam to make a presentation to the taxpayer to discuss the IRS's findings on all issues before finalizing the NOPAs. The discussions should focus on understanding the taxpayer's position; determining whether the taxpayer agrees with the IRS's view of the facts; and determining whether the taxpayer agrees with (or is willing to concede to) the IRS's view of any of the legal issues. The roadmap indicates that the goal of this dialogue with the taxpayer is to help the IRS assess the strength of its positions, the risks associated with pushing the issue forward, and the best approach for ultimately presenting the issues. The roadmap sets the 20th month as the target deadline for issuing the final NOPA after all such resolution efforts have concluded.

After issuance of the final NOPA, if the taxpayer and the IRS are able to come to an agreement on the issues, then the IRS Exam must:

- Consider Rev. Proc. 99-32 1999-34 IRB 1, ramifications/elections;
- Discuss the Rev. Proc. 99-32 options with the taxpayer; and
- Secure a Rev. Proc. 99-32 closing agreement if such relief is properly requested and granted.

The roadmap emphasizes that any such closing agreement should be clear about what transactions and years are covered by the agreement.

If the taxpayer and the IRS are not able to come to an agreement on some of the issues, the roadmap indicates that those issues should be closed out and sent to Appeals by the 24th month of the transfer pricing audit. As part of this process, the roadmap indicates that Exam should:

- Address and rebut the taxpayer's positions raised in its NOPA response;
- Issue the RAR 30-day letter;
- Complete a rebuttal to the taxpayer's 30-day protest by the 23rd month of the audit; and
- Complete the required mandatory reviews of the NOPA, RAR, and rebuttal to protest prior to the end of the 24th month.

Interestingly, the roadmap suggests that the process may be delayed and extended if the protest "contains new factual information, raises new factual disputes or presents new economic or legal theories." In that situation, the roadmap indicates that the IRS should "consider re-engaging the examination process" and "[r]e-evaluate the timeline and reset milestones as appropriate." Thus, the taxpayer should be careful not to put any new facts, new factual disputes, or new economic or legal theories into the protest, unless it has decided that it is more beneficial to include those items (despite the increased risk of a lengthier audit) than to not include them and simply let the case go to Appeals.

The roadmap also emphasizes that several post-closing activities should take place. First, "the same team members participating in the examination" should prepare for and attend the Appeals preconference meeting, coordinating with the TPP in the process. Second, Exam should review the Appeals case memorandum and attend the post-Appeals meeting to understand Appeals' rationale for the outcome, consider the impact it has for the risk assessment in subsequent years, and provide feedback to the TPP.

Conclusion

The transfer pricing audit roadmap provides important guidance to, and sets forth key expectations for both, the IRS examination team and the taxpayer for the conduct of an IRS transfer pricing examination. It starts with the assumption that the taxpayer prepared strong transfer pricing documentation and is prepared to discuss thoroughly its transfer pricing. The repeated exhortation is to communicate fully and openly to produce either an agreed or fully developed unagreed case. While the roadmap may be seen as placing additional burdens on taxpayers during the examination process, it does provide opportunities to resolve cases at the lowest level possible if both sides prepare and approach the process with open minds.

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Italy Clarifies, Amends Transfer Pricing Rules

Italy's Finance Act for 2014 delivered a long-awaited clarification on the applicability of the Italian Regional Tax on Business Activities (IRAP) to transfer pricing adjustments, and introduced changes to the transfer pricing rules applicable to businesses involved in online advertising.

Beginning in fiscal year 2008, the computation rules for IRAP, which until then had been based on the profit and loss results (gross of payroll costs and interest paid, but net of interest received), reevaluated pursuant to the provisions of the Income Tax Code, were amended so that the reference to the latter was eliminated. Because compliance with the arm's length standard is a requirement imposed by the Income Tax Code, it was deemed possible to exclude transfer pricing adjustments for IRAP purposes.

The tax authorities and most tax offices always challenged that interpretation, and continued assessing transfer pricing violations for IRAP purposes, forcing taxpayers to make a difficult decision whether or not to accept assessments or resort to complex litigation.

The Finance Act – Law no. 147 of 27 December 2013, in force from January 1, 2014 – has solved the issue, confirming that IRAP will apply to transfer pricing adjustments. The law implicitly admits that the previous legislation was confusing, because the new law provides that no administrative penalties will be imposed for IRAP purposes in cases of transfer pricing assessments related to fiscal years 2008 through 2012, except for tax assessments that were already final on or before December 31, 2013.

New transfer pricing rules for companies engaged in online advertising services

The Finance Act also introduced a special regime regarding the determination of profits of multinational enterprises that operate in Italy in the online advertising services industry.

This measure was inspired by OECD discussions regarding base erosion and profit shifting, with particular reference to the electronic commerce sector.

The new rule limits the choice of profit level indicators that may be used to determine the transfer prices of Italian-based companies that belong to multinational groups that operate in the online advertising sector. Specifically, the new regime will apply to companies based in Italy that have intercompany relationships with foreign entities of the same group and are engaged in the sale of online advertisings or undertake ancillary activities relevant thereto.

Those companies will no longer be allowed to be remunerated based on cost-plus methodologies, and that limitation could be overcome only through an advance pricing agreement.

The new rules are effective January 1, 2014; however, no implementation decree or any tax authority guidance have been issued regarding: the kind of activities that will be included in the definition of "provision of online advertising services."

Scope of advance tax ruling procedure expanded

Article 7 of the Law Decree called "Destinazione Italia" issued by the Italian government on December 23, 2013, as converted by the Law of February 21, 2014, expands the scope of the advance tax ruling procedure to allow nonresident entities operating in Italy to request a ruling from the tax authorities on whether the nonresident's activities create a permanent establishment in Italy under Italian domestic law or tax treaty provisions.

According to the decree, the initial ruling application must contain a description of the nonresident's activities to be carried out in Italy. Based on this information and discussions with the nonresident (and its Italian tax advisors), the Italian tax authorities will determine whether a permanent establishment would be created.

The new measure extends a ruling's term from three to five tax years – the year in which the agreement is concluded and the subsequent four years.

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Poland Issues Clarification on Business Restructuring Rules

Poland's Ministry of Finance on 27 February[4] published on its website a document clarifying the rules regarding business restructurings between related parties. The document presents the ministry's technical position on the interpretation of the new business restructuring section of the Transfer Pricing Ordinance that entered into force in July 2013. The clarification explains how the ministry views key elements of the new business restructuring regulations, and will impact how tax administrations and taxpayers interpret those regulations.

The ministry's clarification indicates areas of particular interest to the tax authorities and the methodology they should apply when analyzing business restructuring cases. It is highly recommended that companies planning to enter into business restructuring processes (as well as taxpayers that underwent such a process in recent years) review the clarifications and act accordingly.

The ministry's clarification is to a large extent based on Chapter 9 of the 2010 OECD transfer pricing guidelines; it refers specifically to those sections of the OECD guidelines that support the position taken by the Ministry of Finance.

[4] The current version of the document is dated 3 March 2014.

The document includes a more precise definition of what constitutes a business restructuring – the transfer of economically important functions, assets, or risks. “Economic importance” should be analyzed in the context of the profit potential that it being shifted from one related entity to another following the transfer of functions, assets, or risks. Moreover, profit potential is not a separate asset, but a potential attached to and transferred along with certain functions, assets, or risks.

The clarification provides a clear indication that arm’s length remuneration is due for shifting profit potential.

The clarification includes a description of situations in which taxpayers’ actions may be classified as business restructuring cases, such as transfers of tangible or intangible goods, and the termination of contractual rights (through termination or renegotiation of existing contracts), etc.). This list is intended to help taxpayers identify the possibility that the business restructuring regulations may apply in their cases.

The clarification indicates that the impact of restructuring, including the need to pay remuneration for the transfer of profit potential, may occur over a period of time, and may not be a one-off event. This may significantly impact the analysis of the timing of expiration of the statute of limitations in business restructuring cases.

Stressing the role of substance in business restructuring analysis, the clarification directly states that only those business restructuring cases that lead to the transfer of functions, assets and risks to an entity that has sufficient human (and other) resources to perform those functions, use the assets, and control/manage the risks may be justified from an economic perspective. The Ministry of Finance stresses that it is vital that the entity taking over the functions, assets, and risks employs personnel that have sufficient decision-making power and competence to actually perform management functions.

According to the clarification, transfer pricing rules, including comparability analysis, should be applied in the analysis of business restructuring cases. In other words, business restructurings are subject to transfer pricing regulations.

The key areas of analysis, according to the clarification, are:

- Restructuring transactions;
- The economic rationale for business restructurings; and
- The options realistically available to the business restructuring participants.

The clarification expands the concept of the possibility to allocate economically important risks (and the profit potential associated with these risks), and stresses the importance of the ability to manage risks (the ability to make decisions related to accepting the risk and the methodology of risk management) and the financial ability to absorb the effect of the potential materialization of the risk. The ministry also stressed the importance of whether the reduction of risk is commensurate with the reduction of profits.

The clarification contains a technical interpretation of the business restructuring regulations that will be applicable to all new tax audit cases initiated after the update of the Transfer Pricing Ordinance came into force on 18 July 2013, as well as to tax audit cases for open tax years. This means that intercompany transactions involving business restructurings and the payment – or lack of payment – of due compensation in years still open for tax audit purposes will be audited in accordance with the new rules.

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