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Global Transfer Pricing

Arm’s Length Standard

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In this issue:

OECD BEPS Transfer Pricing Deliverables on Track for September G20 Review and Approval

The Organization for Economic Cooperation and Development has made considerable progress on the OECD/G20 base erosion and profit shifting (BEPS) project toward the goal of approval by the G20 in September 2014 of the 2014 BEPS Action Plan deliverables of the two transfer pricing action items.

During the past month, the OECD has held several important events at which progress on the 2014 transfer pricing deliverables was discussed. On May 19, the OECD held a public consultation in Paris on draft changes to the documentation rules in Chapter V of the OECD transfer pricing guidelines; on May 26, the OECD held a webcast to provide updates to the public on the BEPS project, including the 2014 transfer pricing deliverables on intangibles and documentation; and on June 2 and 3 the OECD, together with international business organizations, held its annual International Tax Conference in Washington, DC. Taxpayers have closely monitored these developments to help plan for the inevitable impact on their transfer pricing policies and tax dispute resolution processes.

Current Status

With respect to the transfer pricing Action Plan items, Marlies de Ruiter, head of the Tax Treaty, Transfer Pricing, and Financial Transactions Division of the OECD’s Center for Tax Policy and Administration, stated at the Washington, DC conference that Working Party No. 6 has substantially agreed to the revised text of Chapters I, II, V, and VI of the OECD transfer pricing guidelines. However, the OECD has recognized that the work on the 2014 BEPS Action Plan deliverables will be affected by the 2015 Action Plan deliverables and, therefore, certain sections will not be final when they are released to the public later this year.

Although the work of the OECD on BEPS is not complete, increasingly countries are not waiting for the final reports to take unilateral action. Especially with respect to the transfer pricing items, local tax authorities are moving ahead with inquiries focusing on both information and theories they believe are consistent with the direction of the Action Plan items.

Intangibles

De Ruiter did not indicate whether WP6 made any significant changes to the revised discussion draft on transfer pricing aspects of intangibles released to the public in July 2013. However, de Ruiter acknowledged that Actions 8 (transfer pricing aspects of intangibles), 9 (transfer pricing aspects of risk and capital), and 10 (transfer pricing of high-risk transactions) of the BEPS Action Plan will have a significant impact on Section B of the revised discussion draft, which addresses the criteria for the entitlement to intangible returns. Therefore, this section of the guidelines will not be in final form when the G20 approves the 2014 deliverables in September, so that the OECD can take the transfer pricing Action Plan items deliverable in 2015 into consideration. De Ruiter announced that WP6 will begin "priority" work on these items and expects to publish a discussion draft on those issues in December 2014. De Ruiter stated that this new work will provide guidance on the most challenging BEPS transfer pricing issues. Among the specific issues that will be considered are returns to risk, "excessive" capitalization, low functionality, and mere contractual assumption of risk. De Ruiter said approaches will be developed "either within the arm's length principle or outside, either by special measures or not by special measures."

It is unclear whether WP6 has reached complete consensus on the functions that will determine the entitlement to intangible returns. Clearly, it has acknowledged that capital and risk play an important role in determining entitlement to intangible returns. At the OECD's Washington, DC conference, the U.S. representative to WP6 indicated a preference for an upfront analysis similar to the cost sharing "investor model" to determine the returns to capital and risk. It is not clear the extent to which other countries' representatives share the U.S representative's view that such an analysis is appropriate in all cases, in particular cases in which the capital provider is unable to appropriately manage the deployment of its capital.

Speakers at the Washington D.C. conference indicated that the July 2013 revised discussion draft language on location-specific advantages and passive association was unlikely to change. Although these are not considered intangibles, they are likely to have a significant impact on a transfer pricing analysis when applicable.

The full parameters of the OECD's work on intangibles are unlikely to be known until 2015. However, low-functioning entities that primarily rely on the provision of capital and the assumption of contractual risk to earn intangibles returns may not find support for their position in the final OECD guidance. Tax authorities throughout the world have already gotten the OECD's message and are increasingly challenging the returns earned by low-functioning entities. Some current international structures may face heightened scrutiny based upon the final OECD guidance. Therefore, it may be worthwhile to review the functions and risks of group entities currently earning intangible returns in light of the OECD direction to be prepared in the event of an examination by tax authorities.

Documentation

De Ruiter announced that WP6 has reached consensus on a new approach to transfer pricing documentation, which will include three levels of documentation:

- A country-by-country (CbC) template that will provide high-level financial and activity information for group members that will be used for risk assessment;
- A master file that will provide a big-picture view of the business's global operations; and
- A local file that will provide a detailed transfer pricing analysis.

WP6 had announced previously that the information to be contained in the CbC template would be reduced from 14 items to eight items in six categories. Unfortunately, WP6 has not released the definition of items that will be required. For example, WP6 has stated that the template will require revenue earned on an aggregate country basis by all enterprises in the country. WP6 has not stated whether the revenue will need to be broken down between third-party revenue and related-party revenue, as had been indicated in some releases. Similarly, WP6 has stated that companies will need to provide aggregated accrued taxes on a country basis. However, WP6 has not stated whether accrued taxes are taxes accrued for financial statement purposes or just accrued but unpaid current taxes. These definitions will have a major impact on the burden on business to collect the data.

On the webcast and at the Washington, DC conference, de Ruiter stressed the increased transparency that will result from the three-part disclosure. This increased transparency will provide local tax examiners, sometimes for the first time, sufficient information to understand the profits and profit drivers of the entire group, de Ruiter said. The increased transparency will enable local examiners to determine whether income is being earned where value is being created. De Ruiter provided an example of a service fee charged to a local enterprise. The CbC template would provide the profit earned by the entity providing the service, the master file would provide information on how the service fee related to the overall business of the enterprise, and the local file would explain how the service fee provided a benefit to the local company.

De Ruiter stated that WP6 recognizes that a structured and careful implementation of the new documentation tools will be key to their success for both governments and businesses. She stated the implementation should result in:

- Consistency in governments' adoption of the requirements for all three documentation elements;
- Timeliness of relevant information made available to governments;
- Confidentiality of commercially sensitive information;
- A balancing of costs for both taxpayers and tax administrations; and
- Security that information is used only as intended.

This work will, in part, address whether the CbC template – and possibly the master file – will be filed in the home country or locally. In addition, business has expressed concern that the CbC template will result in increased controversy. WP6 will also look at methods to reduce the risk of double taxation. WP6 recognizes that it needs more time to analyze the implementation strategy and assessment mechanism, and expects to circulate a draft addressing these issues in January 2015.

U.S. Treasury officials have suggested that they have enough regulatory authority to adopt the rules through changes in U.S. regulations. In other countries it will depend on the source of their local documentation requirements. The OECD has not suggested a date by which most countries would be expected to adopt the new requirements. Our best guess is that the new requirements will become effective widely either for 2016 or 2017. Notwithstanding the delayed effective date, local examiners are not waiting for the official release and adoption of the new requirements. Local examiners in some countries are already requesting some of the global information contained in the CbC template during audits.

Clearly, the three-tier documentation process will increase global transparency. For some companies, the increased transparency may expose additional transfer pricing issues or inconsistencies in their transfer pricing practices that they may want to address before their first filing. In many situations, the increased transparency will put an additional premium on adoption and implementation of globally consistent transfer pricing policies.

The new requirements will require most companies to provide additional information in their documentation. The new CbC template will require companies to collect financial information that has never been collected in that form. In addition, the master file contains specific requirements for information that most companies have not previously collected. It is intended that both the CbC template and the master file be prepared by the parent company. For companies that do not have a centralized documentation process, these new requirements will likely require changes to their approach to transfer pricing documentation.

Next Steps

WP6 is expected to finalize 2014 transfer pricing deliverables of the BEPS Action Plan soon. The text is expected to be sent to the 44 members and associates of the OECD's Committee on Fiscal Affairs for discussion and final approval at their meeting at the end of June. The text adopted by the Committee on Fiscal Affairs is expected to be approved at the G20 meeting of finance ministers on September 20 and 21. Pascal Saint-Amans, Director of OECD's Center for Tax Policy and Administration, indicated at the Washington, DC conference that this version of the documents will be released to the public in September, shortly before the G20 meeting.

The U.S. Treasury Department's Deputy Assistant Secretary (International Tax Affairs), Robert Stack, is scheduled to speak at the International Tax Review Global Transfer Pricing Forum to be held in Washington on September 22-23, and his remarks will be closely followed. Companies should continue to closely monitor these developments and be prepared to make appropriate adjustments to their global transfer pricing policies and their approach to resolving transfer pricing disputes.

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The Economics of Business Restructuring and Exit Charges

> "*A production facility with high fixed costs, relative to variable costs, is said to have high operating leverage. High operating leverage means high risks.*" – Principles of Corporate Finance, Brealey, Myers & Allen, 2008, Page 249.

The purpose of this article is to explain the economics of business restructuring and discuss the rationale, if any, for exit charges to compensate for the loss of expected profits resulting from the restructuring.[1] We will discuss a transaction that occurs every day around the world when a controlled manufacturer or distributor is restructured into a so-called contract-manufacturer or low-risk distributor (LRD). The de-risking of the entity is achieved contractually through a change in the transfer pricing policy – no functions or assets are moved from one entity to another.[2]

Because no apparent substantive changes take place at the restructured entity, tax authorities tend to be skeptical of this type of restructuring transaction. Indeed, they will often argue that some underlying intangible asset of the restructured business must have been transferred. This alleged transfer of an intangible asset is thus seen as a taxable event that requires that a taxable consideration be levied on an arm's length exit charge. The exit charge is then calculated as the present value of the net stream of expected intangible income associated with the intangible asset allegedly transferred.

When no intangible assets are to be found, tax authorities often make an alternative argument based on the assertion that no uncontrolled party would ever willingly agree to give up a stream of positive expected income without being duly compensated upfront. Compensation that makes the entity indifferent between its income pre- and post-restructuring is therefore required.[3] In that case, the exit charge is exactly the present value of the stream of expected income lost to the restructuring. From the perspective of the skeptical tax authorities, the only thing that really appears to have been meaningfully restructured in the transaction is the taxpayer's local tax liability; the search for a basis to support a transfer pricing adjustment through an exit charge is then performed under audit. The exit charge counteracts the erosion of the taxable base the restructuring has created through the shift in the restructured entity's profit.

Taxpayers and transfer pricing professionals, on the other hand, will argue that the restructuring transaction has nothing to do with the transfer of an intangible asset – in fact, most entities that are restructured do not own any valuable intangible assets. The restructuring is about reallocation of risk, similar to a situation whereby the restructured entity is purchasing insurance against market volatility in the form of a guaranteed return. The reduction in expected future income is thus the price of that insurance. It follows that, as long as the functions associated with the exercise of control over the risk transferred from the restructured entity to the principal are performed by the principal post-restructuring, the transaction should be respected, and no further exit charge is warranted.[4]

When presented with that explanation, tax authorities will often counter that the transaction lacks economic substance because the de-risking has occurred entirely through contract and not through any meaningful transaction that can be observed in the market place, where something we can point to, beyond the control of risk, is transferred from one party to another to justify the reduction in the restructured entity's target income.

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[1] I am very grateful to Larry Powell for pointing out to me years ago that providing a guaranteed return to an entity does not fully de-risk that entity. That comment forced me to think about what that guaranteed return really achieves from an economic standpoint. I am also very grateful to Marco Fiaccadori, Steven Davis, and Arin Mitra for various insightful comments that have resulted in a much better article. Final thanks go to Betty Fernández for her editorial assistance. The ideas expressed in this article are those of the author and should in no way be construed as representing the positions of Deloitte Tax LLP.

[2] As will be discussed herein, a transfer of control over certain functions and assets may be required to satisfy economic substance requirements.

[3] The lack of distinction between "income" and "value" is to be emphasized. We will come back to that important distinction later in the article.

[4] It is beyond the scope of this article to address or discuss incentive compatibility issues that may arise in the context of multiperiod contracts such as those considered herein. We are not ignoring this issue because we believe it is not a relevant one. It is a relevant issue that should be studied using the vast economic literature that exists on optimal contract theory and mechanism design. However, the purpose of this article is not to propose a comprehensive theory of business restructuring, but rather to focus on identifying and valuing the economic quantum transferred in said restructuring. Further research will undoubtedly address incentive compatibility issues in transfer pricing, not just in connection with business restructurings but in the larger context of any multiperiod controlled relationship.

Are tax authorities correct in asserting that no meaningful economic quantum has been exchanged to justify the reduction in the target income of the restructured entity? Are taxpayers and transfer pricing professionals correct in asserting that the restructured entity has purchased, in substance, insurance against market volatility when agreeing to a lower target expected income post-restructuring?

Answering these questions will be more straightforward once the economics of business restructuring are understood. We encourage the Base Erosion and Profit Shifting (BEPS) working groups at the Organization for Economic Cooperation and Development (OECD) addressing business restructurings to consider the specific economics of business restructuring and consequently to apply the economics to properly implemented and valued transactions. In the next section, we elaborate on how the work contained herein fits within the work currently being done at the OECD pursuant to Actions 8,9, and 10 of the Action Plan on Base Erosion and Profit Shifting.[5]

BEPS Actions 8, 9, and 10

The headline of BEPS Actions 8 (intangibles), 9 (risk and capital) and 10 (other high-risk transactions) is to "assure that transfer pricing outcomes are in line with value creation." At the same time, the arm's length standard has been reaffirmed both on page 14 of the action plan and in public remarks by OECD officials.[6]

The arm's length standard requires controlled outcomes to replicate outcomes produced by markets under comparable circumstances. Understanding market outcomes under various fact patterns is what the field of economics is all about. Unfortunately, tax policy debates – including transfer pricing debates such as those taking place at the BEPS working groups – focus more on accountants and tax lawyers' perceptions of how markets work than on actual, solid economic analysis thereof. Take for example the headline for Actions 8, 9, and 10. Do markets allocate returns in line with value creation? We are not aware of any economic theory claiming that to be the case. We are, however, aware of decades of economic research showing theoretically and empirically that returns are allocated in line with systemic risk borne. Therefore, to the extent the word "value" in the quoted headline means systemic risk-adjusted value, BEPS Actions 8, 9, and 10 could lead to meaningful insights and useful policy guidance. If not, guidance and policy restrictions inconsistent with market outcomes – and hence inconsistent with the arm's length standard – will result.

For readers unsure about what the previous paragraph really means, consider Action 10, which seeks to curtail the use of contractual de-risking of an entity to shift profit and erode the taxable base – call that a restructuring transaction. It is at the heart of this article. One way to look at this transaction is to say that nothing of substance has changed pre- and post-restructuring; the same value is created pre- and post-restructuring at the same physical location using the same assets and having the same people performing the same functions; therefore, the market would keep the restructured entity's profit post-restructuring equal to what it was pre-restructuring.

That view of how markets work supports the imposition of an exit charge equal to the present value of the decrease in profitability suffered by the restructured entity. However, the correct application of economics would suggest otherwise. To the extent the restructuring has lowered the systemic risk of the restructured entity, the income required to maintain the systemic risk-adjusted value of the enterprise to what it was pre-restructuring is necessarily lower. When that decrease in income is calculated correctly – based on a measurement of the decrease in systemic risk, clearly no exit charge makes sense because the pre-restructuring and post-restructuring enterprise values are equal at zero exit charge.

Unless the BEPS working groups rely in their work on well-accepted economic principles, definitions and analyses to provide the guidance that is expected to police the intercompany transactions of the future, significant distortions in the capital markets will result in lowering social welfare – not increasing it, BEPS's mission as stated on page 8 of the Action Plan.

The Economics of Business Restructuring

Contrary to what some tax authorities believe, a restructuring transaction of the type discussed earlier, when done properly, does have meaningful economic substance, and is observed regularly in the market place. It is neither merely a "paper" transaction, nor is it an insurance transaction, as transfer pricing professionals often assert.

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[5] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en.

[6] *See, for example*, Pascal Saint-Amans, director of the Center for Tax Policy and Administration at the OECD speaking on March 31 at a tax conference in Paris.

The restructuring transaction transforms the fixed costs of the target into variable costs through a change in transfer pricing policy.[7] A reduction in the proportion of fixed costs to total costs results in a reduction in cost of capital. A reduction in cost of capital means less systemic risk. Less systemic risk means less expected return required to stay on the efficient risk-return frontier.

When tax authorities assert that direct exchanges of systemic risk for expected return do not occur in the market place, they are entirely correct – moving along the efficient risk-return frontier requires trading assets; assets are the objects traded directly in the market place. Assets are promises of cash inflows and obligations of cash outflows. The size, nature, contingency structure, and timing of these cash inflows and outflows combine to determine the systemic risk of the underlying asset. The absence of arbitrage in a competitive market is what ensures that the law of one price will assign a uniquely determined expected return to the level of systemic risk the asset is exposed to.

So who has taken on the fixed costs of the restructured entity? The principal has, when it agreed to compensate the restructured entity with a guaranteed return. The economic quantum being traded in the transaction, which gives rise to the economic substance of the transaction, is thus all fixed costs faced by the target pre-restructuring going from the target to the principal. The target is left post-restructuring with all costs being variable costs. The result of that trade is a reduction in the systemic risk of the restructured entity, and an increase in the systemic risk of the principal. The target is willing to pay to face a lower cost of capital and the principal requires compensation to face a higher cost of capital. That payment is equal to the reduction in the expected income of the restructured entity.[8] Note that no one bought or sold insurance at any point in time in that transaction.[9]

Uncontrolled transactions involving the exchange of fixed costs for consideration are observed in every co-promotion transaction in the pharmaceutical industry, in co-financing deals in the entertainment industry, and in co-development transactions that involve one party doing the development work and the other financing a portion of the associated costs, regardless of the industry. In fact, the exchange of fixed costs for consideration is a sanctioned transaction under the United States Treasury Regulations and in the OECD transfer pricing guidelines – that is what cost sharing arrangements are all about.[10] [11] So if trading fixed costs for consideration is legitimate and has economic substance in the context of cost sharing arrangements, why would it not in the context of business restructuring transactions?

The Economics of Exit Charges

When implemented properly, the restructuring transactions under discussion are about restructuring the cost structure of the target.[12] Specifically, the new transfer policy of a guaranteed return transforms all fixed costs of the restructured entity into variable costs. This in turn reduces the cost of capital of the restructured entity – that is a benefit the restructured entity is willing to pay for. The price the restructured entity is willing to pay for that benefit is the reduction in expected operating

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[7] We will sometimes use the word "target" to denote the entity as a restructuring candidate.

[8] Under Treas. Reg. §1.482-1(d)(3)(ii)(B) and Treas. Reg. §1.482-1(d)(3)(iii)(B)(3), one could argue that the transfer of fixed costs requires a transfer of control over the assets and functions that give rise to the fixed costs being transferred in the restructuring (such as productive capacity decisions, pricing decisions, and marketing strategy decisions).

[9] An insurance transaction does not involve trading systemic risk and expected return directly either. It involves trading an asset that creates an obligation for the buyer of the asset to make non-contingent payments of the insurance premiums, and an obligation for the seller of the asset to make payments contingent on some specified event occurring (for example, a fire or an accident).

[10] In a cost sharing arrangement, the foreign participant agrees to fund a portion of the development costs that the owner of the intangible assets would otherwise have to fund. That migration of the obligation to fund a fixed cost raises the cost of capital of the foreign participant and reduces the cost of capital of the intangible assets' owner. The intangible assets' owner thus loses the expected stream of intangible return associated with the intangible asset funded by the foreign participant, but gains the opportunity to face a lower cost of capital. Netting those economic costs and benefits determines the party obligated with an upfront payment to the other party to enter into the cost sharing transaction.

[11] For a full treatment of the economics of cost sharing arrangements, see Philippe G. Penelle, "The Mathematics of Cost Sharing under the Income Approach", BNA *Transfer Pricing Report*, 21(13), November 1, 2012.

[12] In our experience, restructuring transactions are rarely implemented properly. For example, for such transaction to be meaningful to a distributor, the transfer pricing policy pre-restructuring must be to target an operating margin based on forecasts and year-end adjustments performed only when the actual financial results are outside the range, whereas in the post-restructuring transaction the transfer pricing policy must be such that the lower target operating income be achieved on actual financial results.

income that should be targeted post-restructuring. This valuation should include any future expected return associated with prior investments incurred by the restructured entity to retain incentive compatibility in the original contractual arrangement.

Suggesting that the restructured entity should then be compensated for the loss of operating income it suffered with the payment of an exit charge equal to the present value of the income expected to be lost is illogical, because it would allow the restructured entity to operate at the lower cost of capital but without having to pay for that benefit. For the principal that agrees to take on the fixed costs the restructured entity used to face pre-restructuring, the resulting increase in its cost of capital is a cost that requires compensation. That compensation is exactly equal to the reduction in operating income of the restructured entity post-restructuring. Having to pay an exit charge equal to the present value of the income expected to be gained is also illogical because it would force the principal to operate at the higher cost of capital but without compensation for that cost.

This is the economics of restructuring entities by contractually de-risking them through a change in the transfer pricing policy. The quantum being traded is fixed costs. Fixed costs are moved off the books of the restructured entity and onto the books of the principal. Along with those costs, certain control functions associated with the functions and assets giving rise to those costs may need to be transferred as well.

A discussion of the impact of that transfer of fixed costs on the cost of capital of both the principal and the restructured entity appears to be absent from published discussions on this type of transaction, including in Chapter 9 of the OECD transfer pricing guidelines, yet explains why exit charges in this type of transactions are illogical.[13] When the restructured entity does not have any fixed costs, an exit charge equal to the present value of the loss of expected income is the correct answer. It is the correct answer because if all the costs of the restructured entity are variable pre-restructuring, changing the transfer pricing policy to a cost-plus or a guaranteed operating margin has no impact on the cost of capital of the restructured entity. The restructured entity is therefore not willing to accept a lower expected income as the price to pay for the reduction in its cost of capital because there is no reduction in its cost of capital in the first place. Thus, any reduction in expected income must be compensated through an exit charge. In that case, the restructuring is economically meaningless and tax authorities are justified to request a taxable exit charge.

The other typical case when an exit charge may be warranted is when the reduction in expected income is not calculated using the correct methodology. The correct methodology requires a calculation of the reduction in the cost of capital of the restructured entity, or a calculation of the increase in the principal's cost of capital. Therefore, a restructuring that involves benchmarking the expected operating income of the restructured entity using the transactional net margin method (TNMM) or the comparable profits method (CPM) may likely be flawed unless one can find benchmarks that do not have any fixed costs in their cost structure.[14] Unless an analysis of the cost structure of the candidate benchmarks is performed to assess comparability, TNMM and CPM are not effective for measuring what needs to be measured.

Some economists have suggested using service companies to benchmark the return for LRDs because, functionally, service companies appear fairly similar to LRDs in term of the nature of the economic resources required in their respective businesses.[15] We believe this approach may be more reliable than attempting to find real LRDs in the marketplace, because the cost structure of service companies should comprise mostly variable costs with very little fixed costs. In that sense, LRDs and service companies are fairly comparable.

When trying to determine the target return of the restructured entity, transfer pricing professionals typically attempt to directly identify low-risk manufacturer or low-risk distributor benchmarks in the market place. Achieving that goal may be elusive, because systemic risk is unobservable – after all, if we could observe systemic risk we would not need to use assets and functions as proxies for risks when we perform transfer pricing studies. And when we contractually de-risk an entity with the type of transaction we are discussing, we are leaving all assets and all functions exactly as they were before the restructuring – and yet we contend that the systemic risk of that entity has meaningfully decreased.

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[13] At the risk of repetition, this statement is valid only if the restructuring transaction is implemented properly.

[14] Companies with no fixed costs whatsoever exist in the abstract world of economic theorists, but probably not in the real world.

[15] *See*, for example Aydin Hayri and Michael Aarstol, "Neither a Distributor Nor a Commissionaire: Benchmark Returns for Low-Risk Distributors," *Transfer Pricing Report*, July 2003.

It is thus illogical to argue on the one hand that two entities with the same assets and functions can have different levels of systemic risks (the pre-restructured entity versus the post-restructured entity), and then argue a minute later, when we are benchmarking the return of the post-restructured entity, that by looking at the assets and functions of benchmarks we know what level of systemic risks they are exposed to – in other words, assets and functions become suddenly perfectly correlated with systemic risk.[16] It must be one or the other, not one when convenient and the other when convenient.

The reality is that assets and functions do not, in and of themselves, drive systemic risk; what drives systemic risk are the fixed costs that performing certain functions and developing certain assets require, and the systemic risk to which the resulting cash inflows are exposed. A good example of that is the development of intangible assets. Developing intangible assets does not create systemic risk that was not there before the development activity started. Development risk is diversifiable; hence, it is by definition not systemic. Developing intangible assets increases systemic risk because of the fixed costs the development activity requires. Fixed costs magnify the systemic risk that is already there.

The proper way to calculate the target operating income of the restructured entity does not involve a benchmarking exercise – it involves imposing a no-arbitrage condition. Once one understands the nature of the restructuring transaction – namely, restructuring the cost structure of the target by transforming its fixed costs into variable costs – benchmarking the appropriate target operating income of the restructured entity can easily be done by requiring that the target be indifferent between: (i) not being restructured, keeping funding the fixed costs, and facing the greater cost of capital; and (ii) being restructured, having its fixed costs become variable costs, and facing the lower cost of capital. Imposing that no-arbitrage condition provides the target operating income of the restructured entity. This is all achieved without a single TNMM or CPM search for contract manufacturers or LRDs that may not exist in the marketplace.[17]

Even if those comparable companies existed, we would not be able to identify them, because observing assets and functions is not sufficient to make a reliable inference about the level of systemic risk of those companies. Remember, the restructured entity has lower systemic risks than before the restructuring and yet it has exactly the same assets and performs the exact same functions as before the restructuring. Also remember that we are asserting that we are not doing anything that does not exist in the marketplace. So we must be saying that, in the marketplace, you could find a number of companies that have the same assets and perform the same functions, but face very different systemic risks, and a number of companies that have different assets and perform different functions but face the same systemic risks. If that is the case, using TNMM or CPM to benchmark the return of the restructured entity using assets and functions to assess comparability is a hopeless exercise.

Indifference Applies to Tax Authorities

Tax authorities challenging a loss of expected tax income to the type of business restructuring we have been discussing miss an important point. A reduction in the level of expected tax does not mean a reduction in the value of tax to be collected. Remember that tax liability is calculated as a percentage of some measure of gross revenue net of all allowable deductions. All variable and fixed costs required to run the business are, in most countries, allowable tax deductions. It follows that the expected tax payments pre- and post-restructuring of the restructured entity are exposed to different systemic risks themselves. When the valuation of the business restructuring is done properly using the no-arbitrage condition mentioned earlier, tax authorities in the tax jurisdiction of the restructured entities are also indifferent between collecting tax on the pre-restructured level of expected income – exposed to higher systemic risk, versus on the post-restructured level of expected income – exposed to lower systemic risk. That is the sense in which the value of tax collection is left unchanged by the business restructuring.

At the risk of stating the obvious, a business restructuring of the type we are discussing here does not create or destroy any systemic risk or income in the system – it merely reallocates income and systemic risks between the two controlled

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[16] As noted earlier, Treas. Reg. §1.482-1(d)(3)(ii)(B) and Treas. Reg. §1.482-1(d)(3)(iii)(B)(3) probably require control over the assets and functions that give rise to the fixed costs transferred in the restructuring to be with the principal in the post-restructuring state to meet economic substance requirements. The point remains that observing the location of assets and functions is not particularly informative as to the identity of the party funding the costs and controlling the associated assets and functions that create the fixed costs the restructuring transferred to the principal.

[17] Transfer pricing professionals faced with the reality that they cannot really find meaningful sets of contract manufacturing or LRD benchmarks resort to constructing a range of returns using regular manufacturers and distributors and arguing that picking a low value in that range should provide the correct target for the restructured entity. It is outside the scope of this article to discuss why this methodology is critically flawed, but it is critically flawed.

participants in a way that leaves values unchanged for both participants; that is why they are indifferent between the pre- and the post-restructuring states. If both controlled participants are indifferent between the pre- and post-restructuring states and the total pie is unchanged, then tax authorities should be indifferent as well.

For economists and mathematically inclined readers, the next section demonstrates the validity of the various assertions we have made so far. For non-economists or economists who prefer numerical examples, we then illustrate numerically how to perform the valuation of a business restructuring.

A Model

Although we will center our discussion on the case of a distributor candidate for restructuring into a low-risk distributor – i.e., a distributor without fixed costs – the exact same reasoning and methodology apply when dealing with a manufacturer.

Let $\bar{r}$ denote the cost of capital of a distributor facing fixed costs FC and purchasing its entire inventory from a related party. Assume that the transfer prices are determined at the beginning of the year based on financial forecasts; further assume that the transfer prices are not adjusted throughout the year. Let $\overline{OM}$ denote the target operating margin of the pre-restructuring distributor, and $\overline{OI}$ the target expected operating income to achieve the target operating margin.[18]

Consider a restructuring transaction that will consist of allowing the distributor post-restructuring to hit exactly a given operating margin $\underline{OM}$ with associated target expected operating income $\underline{OI}$. Transfer prices will be adjusted throughout the year to allow the restructured distributor to hit exactly $\underline{OM}$.

Because the restructured distributor is now guaranteed an operating margin that is based on actual financial results, and not just on forecasts, the transfer pricing policy has transformed the fixed costs FC of the restructured distributor into variable costs. The principal selling the tangible products to the restructured entity is now bearing the fixity of those costs.

It is well known that fixed costs magnify the systemic risk to which a company is exposed.[19] Therefore, transforming fixed costs into variable costs results in a reduction in the systemic risk the restructured distributor is facing compared to the systemic risk it faced prior to the restructuring. There is no change in the aggregate systemic risk faced by the two controlled participants; there is, however, a reallocation of that aggregate systemic risk between the two. In a competitive market, a reduction in systemic risk results in a reduction in the cost of capital. In the parlance of the Capital Asset Pricing Model (CAPM), the restructuring of fixed costs into variable costs is moving us along the efficient risk-return frontier.

Let $\underline{r}$ denote the post-restructuring cost of capital the restructured distributor is facing. Let r^f denote the risk-free rate of return. Note that $r^f < \bar{r}$. It follows that:[20]

$$\underline{r} = \frac{\overline{OI} + FC}{\frac{\overline{OI}}{\bar{r}} + \frac{FC}{r^f}}$$

The previous equation allows us to calculate the reduction in the cost of capital of the restructured entity as a function of the size of the fixed costs that the restructuring has transformed into variable costs.

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[18] If the transfer prices are adjusted throughout the year to hit $\overline{OM}$ exactly at year-end, the distributor pre-restructuring is not bearing the fixed costs FC because those fixed costs are already shifted through the transfer pricing policy to the seller of the tangible property. Therefore, no further restructuring of that business is meaningful. This is why the way the transfer pricing policy is implemented is so important.
[19] This has been known since the 1970s, and has been well accepted ever since in the economic literature. Entire chapters are devoted to this topic in every corporate finance textbook, including the textbooks most used in business schools and economic undergraduate programs.
[20] Note that the key assumption is the presence of costs with discount rate r^c such that $r^c < \bar{r}$; they do not need to be perfectly fixed costs. Without loss of generality or insights, the formulae presented herein assume perpetuity and no growth.

Rigorous formal proofs of all formulas and propositions in this article are available from the author upon request. The previous equation states that the cost of capital of the pre-restructuring entity facing fixed costs FC is equal to the cost of capital of the post-restructuring entity facing no fixed costs plus a risk premium that is directly proportional to the operating leverage introduced by the fixed costs. This formula can be found in most corporate finance textbooks. We have just rearranged the terms.

Proposition 1: The cost of capital of an entity that does not bear fixed costs in its pre-restructuring state is the same pre- and post-restructuring.

The proof of that proposition is simple, set $FC = 0$ in the previous equation and note that the equation becomes $\underline{r} = \bar{r}$.

To calculate what the target operating income $\underline{OI}$ should be, impose the no-arbitrage condition that the restructured entity should be indifferent between facing the higher cost of capital $\bar{r}$ at the higher operating income $\overline{OI}$ and facing the lower cost of capital $\underline{r}$ at the lower operating income $\underline{OI}$:

$$\underline{OI} = \frac{\underline{r}}{\bar{r}}\overline{OI}$$

Note that this framework accommodates the restructuring of targets that have developed, or are developing, intangible assets. For those targets, $\overline{OI}$ will include a routine and a non-routine component, and $\bar{r}$ will reflect the incremental level of systemic risk the funding of the fixed costs associated with the intangible development activity introduces. Therefore, upcoming statements about exit charges apply equally apply to the restructuring of entities that do and do not own intangible assets.

Let S denotes sales. It follows that $OM = OI/S$. Using the previous two equations and rearranging the terms, we obtain the fundamental pricing formula that relates the post-restructuring target operating margin of the distributor with its pre-restructuring operating margin (we will refer to the following formula as "Penelle (2014)"):

Penelle (2014):

$$\underline{OM} = \overline{OM} \times \left[\frac{\frac{\overline{OI}}{\bar{r}} + \frac{FC}{\bar{r}}}{\frac{\overline{OI}}{\bar{r}} + \frac{FC}{r^f}}\right]$$

Proposition 2: The post-restructuring operating margin of an entity that does not bear fixed costs in its pre-restructuring state is the same pre- and post-restructuring.

The proof of that proposition is simple, set $FC = 0$ in the previous equation and note that the equation becomes $\underline{OM} = \overline{OM}$.

We are now ready to prove to tax authorities that for entities bearing fixed cost FC, a reduction in the target operating margin of the restructured entity is required to stay on the efficient risk-return frontier. We will write this proposition so that it encompasses Proposition 2.

Proposition 3: The post-restructuring target operating margin of the restructured entity is strictly lower than the pre-restructuring target operating margin of the restructured entity if and only if the pre-restructured entity bears strictly positive fixed costs.

We have already shown that when $FC = 0$ we obtain $\underline{OM} = \overline{OM}$. We are left showing that $\underline{OM} < \overline{OM} \Leftrightarrow FC > 0$. The proof boils down to showing that $\underline{OM} < \overline{OM} \Leftrightarrow r^f < \bar{r}$. Since $r^f < \bar{r}$, we know that when $FC > 0$ we will always have $\underline{OM} < \overline{OM}$.

And for the grand finale we are ready to prove to tax authorities that if the target operating income of the restructured entity post-restructuring is calculated using Penelle (2014), no payment of an exit charge from the principal to the restructured entity is legitimate.

Proposition 4: If the post-restructuring target operating margin of the restructured entity is calculated using Penelle (2014), the payment of an exit charge is not arm's length.

The proof of that proposition is straightforward. Penelle (2014) is the no-arbitrage condition that ensures that both the principal and the restructured entity are exactly as well off in the post-restructuring state as they were in the pre-restructuring state. They both are indifferent between restructuring and not restructuring. Therefore, any other allocation of income between the two at the post-restructuring cost of capital would violate the condition that they are indifferent between the two states. An exit charge from the principal to the restructured entity will make the principal worse off in the post-restructuring state than in the pre-restructuring state, and will make the restructured entity better off in the post-restructuring state than in the pre-restructuring state.

Note that when the valuation of the restructuring is done properly, whether or not the pre-restructuring intercompany agreement can legally be terminated and replaced with a new agreement providing for a fixed return becomes irrelevant and moot – both parties are indifferent between not restructuring and restructuring. Thus, neither party would oppose the termination of the pre-restructuring intercompany agreement. As noted earlier, this comment ignores incentive compatibility issues and dynamic time-consistency issues that are outside the scope of this article.

In the restructuring transaction we have been discussing, the new transfer pricing policy is such that all fixed costs of the restructured business are made variable by the principal. This is a subset of a broader class of business restructurings whereby a controlled participant agrees to take on a subset of the fixed costs of the target, rather than all of the fixed costs. In that framework, FC would denote the portion of the fixed costs at play, and the exact same reasoning as outlined in this section would apply to calculate the correct allocation of expected income pre- and post-restructuring.

A Numerical Example

Consider a distributor operating in a European country where the local tax rate is 30 percent. The distributor purchases its entire inventory from a related party. Assume that the pre-restructuring cost of capital of the distributor is 10 percent. Assume that the pre-restructuring operating margin target of the distributor is 5 percent. The transfer prices are determined at the beginning of the year based on financial projections for the year. No adjustments to the transfer prices are performed during the year. Assume that the third-party sales for the distributor are projected to be \$1,000. Assume that the cost structure of the distributor is such that it faces \$10 of fixed costs.

To achieve an expected operating margin of 5 percent, given \$10 of fixed costs and \$1,000 of expected sales, the transfer prices should be set at \$940, because \$1,000-\$940-\$10=\$50 and \$50/\$1,000=5 percent. The pre-restructured distributor will thus bear \$950 of total costs.

In an attempt to reduce its tax liability, the company decides to create a principal in a lower-tax jurisdiction where the tax rate is 10 percent. The principal will sell the inventory to the distributor and guarantee the distributor a fixed operating margin to be determined. The offer of a guaranteed operating margin requires constant monitoring of the transfer prices during the year to ensure that the distributor earns the correct targeted operating margin at year-end. It is this implementation mechanism that ensures the conversion of the fixed costs of the distributor into variable costs. We illustrate that numerically in the next section.

Assume that the risk-free interest rate is 2 percent. Applying Penelle (2014), we can calculate the correct target operating margin for the restructured entity:

$$3\% = 5\% \times \left[\frac{\frac{\$50}{10\%} + \frac{\$10}{10\%}}{\frac{\$50}{10\%} + \frac{\$10}{2\%}} \right]$$

Because expected sales are \$1,000 and the new target operating income of the restructured entity is 3 percent, the target operating income of the restructured entity post-restructuring is \$30 instead of \$50. The shift of \$20 from a 30 percent tax rate to a 10 percent tax rate results in an expected tax benefit of \$4. The company's effective tax rate (ETR) on that portion of its business has moved from 30 percent to 22 percent.

The distributor's pre-restructuring cost of capital was 10 percent. Given the restructuring of its cost structure from having to pay $10 of fixed costs to not having any fixed costs left in its business, the cost of capital of the restructured entity falls from 10 percent to 6 percent. Indeed, using the first equation:

$$6\% = \frac{\$50 + \$10}{\frac{\$50}{10\%} + \frac{\$10}{2\%}}$$

The distributor is thus indifferent between (i) facing an expected operating margin of 5 percent, fixed costs of $10, and a cost of capital of 10 percent; and (ii) facing a guaranteed operating margin of 3 percent, fixed costs of $0, and a cost of capital of 6 percent. Similarly, tax authorities levying taxes on the restructured entity are indifferent between (i) levying taxes on expected income of $50 facing the greater systemic risk of the pre-restructuring state; and (ii) levying taxes on expected income of $30 facing the lower systemic risk of the post-restructuring state. Indeed,

$$\frac{\$50}{10\%} = \frac{\$30}{6\%} = \$500$$

Calculating an arm's length outcome of the proposed restructuring did not involve performing any TNMM or CPM to find comparable companies to justify the 3 percent operating margin we are going to guarantee the restructured distributor. However, it does require understanding the cost structure of the distributor. Table 1 below shows the correct target operating margin and cost of capital for the restructured entity as a function of the size of the fixed costs it bears, as well as the resulting ETR impact of the restructuring.

Table 1: Restructuring Outcomes as a Function of Fixed Costs

FC	$0	$2.5	$5	$7.5	$10	$12.5	$15	$17.5	$20
$\bar{r}$	10%	8.4%	7.3%	6.6%	6.0%	5.6%	5.2%	5.0%	4.7%
$\overline{OM}$	5%	4.2%	3.7%	3.3%	3.0%	2.8%	2.6%	2.4%	2.3%
ETR	30%	27%	25%	23%	22%	21%	20%	20%	19%

Notice that the existence of very small fixed costs of $5 has a material impact on the cost of capital of the distributor and on the tax impact of the restructuring. When fixed costs are $5, the transfer prices that will leave an expected 5 percent operating margin at the pre-restructuring entity are $945 for a total cost structure of $950. So with fixed costs accounting only for 0.5 percent of total cost we can see from Table 1 that a restructuring transaction transforming the 0.5 percent fixed costs into variable costs results in a reduction in ETR from 30 percent to 25 percent. Notice, however, that regardless of the resulting ETR, the value of the taxes to be collected by tax authorities has not changed pre- and post-restructuring.

Going back to the example in which fixed costs are $10, if tax authorities come in, post-restructuring, and argue that either (i) the transaction has no economic substance because no assets or functions were transferred; or (ii) since the profit of the distributor is lower post-restructuring than it was pre-restructuring it must be the case that an intangible asset has been transferred in the transaction (which requires compensation), the simple explanation is: no assets or functions have been transferred in the restructuring, including no intangible assets. What has been transferred is the obligation to fund a fixed cost. Post-restructuring, the distributor does not fund the $10 of fixed costs anymore; the principal now funds this fixed cost obligation. Once the restructured distributor is no longer obligated to fund a fixed cost, its cost of capital drops from 10 percent to 6 percent. That decrease in cost of capital has a value – the restructured distributor is willing to give up expected income to operate at 6 percent cost of capital instead of 10 percent. Life has become cheaper for the restructured distributor. No assets or functions have been transferred; however, a fixed cost has been transferred.

We finally have something we can point to that has been transferred. The focus of transfer pricing professionals with assets and functions is misguided in this context. Assets and functions are unimportant in determining market outcomes. What is important in determining market outcomes is what it takes to create those assets and perform those functions in terms of the nature of the cost they require and the systemic risk of the cash flows they generate. Transfer pricing professionals should start paying closer attention to the cost structure of the companies for which they work.

Fixed Costs versus Variable Costs

Everything discussed so far is predicated on the concept that the change in transfer pricing policy results in the removal of all fixed costs from the income statement of the restructured distributor. For readers not yet convinced that this is what is happening in the type of business restructuring we are considering, the numerical example we just discussed will illustrate our assertion. The table below shows what happens to the pre-restructured distributor when sales unexpectedly double during the year from $1,000 to $2,000.

Table 2: Pre-restructuring Transfer Pricing Policy

	Forecasts	Actuals	Difference
Sales	$1,000	$2,000	Doubled
Fixed Costs	$10	$10	Did not change
Transfer Prices	$940	$1,880	Doubled
Operating Income	$50	$110	More than Doubled
Operating Margin	5%	5.5%	Increased

The astute reader will notice that the transfer pricing policy is such that when sales double, the cost of purchasing inventory doubles as well – the cost of purchasing inventory is thus a perfectly variable cost for the distributor. This, in turn, means that the actual operating margin of the distributor will have more volatility than sales, because of the existence of $10 of fixed costs. This is indeed the case as when sales double, the realized operating margin of the distributor under the transfer pricing policy is 5.5 percent instead of the targeted 5 percent. Operating income has more than doubled with a doubling in sales. Reciprocally, operating income will shrink by more than half when sales are halved.

We are now going to present the exact same table but for the post-restructured entity that enjoys a guaranteed operating margin at 3 percent.

Table 3: Post-restructuring Transfer Pricing Policy

	Forecasts	Actuals	Difference
Sales	$1,000	$2,000	Doubled
Fixed Costs	$10	$10	Did not change
Transfer Prices	$960	$1,930	More than Doubled
Operating Income	$30	$60	Doubled
Operating Margin	3%	3%	Did not change

Total costs for the distributor is the sum of the fixed costs of $10 and the cost of purchasing inventory. In the pre-restructuring state, when sales doubled, total costs for the distributor went from $950 to $1,890, which is less than a doubling. This was because of the $10 of fixed costs. In the post-restructuring state, when sales double, total costs for the distributor increase from $970 to $1,940, which is exactly a doubling of total costs despite the $10 of fixed cost. Total costs doubling when sales double means, by definition of variable costs, that all costs have become variable.

This is the sense in which the restructuring, through the change in transfer pricing policy, has transformed the $10 of fixed costs into variable costs. This is also the sense in which a business restructuring of the type we are discussing will only achieve its goals and be meaningful if implemented properly – the operating margin of the restructured entity has to be guaranteed post-restructuring and cannot be guaranteed pre-restructuring. If the distributor is already enjoying pre-restructuring a guaranteed operating margin, lowering that target operating margin in an alleged restructuring is meaningless – an exit charge exactly equal to the present value of the income shift is required.

Conclusion

Meaningful business restructuring is about taking an entity that bears fixed costs and is not guaranteed a fixed return through the transfer pricing policy and changing that transfer policy so that post-restructuring it is provided a guaranteed return. That change in transfer pricing policy shifts the burden of financing the fixed costs of the target's business to the principal. That, in turn, lowers the cost of capital of the target and increases the cost of capital of the principal. The reduction in expected operating income for the restructuring target such that it is indifferent between not being restructured and facing the higher cost of capital and being restructured and facing the lower cost of capital, is calculated by imposing that no-arbitrage condition and by solving it – not by finding contract manufacturing or LRD benchmarks. We developed and provided a formula in this article – Penelle (2014) – that performs the correct valuation of the target operating income of the restructured entity. When the implementation of the restructuring and the valuation thereof is done properly, imposing an exit charge is not only unnecessary, it is wrong because it allows the restructured distributor to operate at the lower cost of capital but without paying consideration for that economic benefit. Tax authorities should also consider that the value of taxes to be collected pre-restructuring and post-restructuring has not changed whatsoever as a result of the restructuring. Everyone involved in the restructuring, including tax authorities, is indifferent between restructuring and not restructuring.

Are we able to point to something that has been transferred from the restructured entity to the principal in a business restructuring? Although it is not an asset or a function, we can point to a meaningful economic quantum that the restructuring has transferred, namely, a fixed cost. The restructuring has transferred a fixed cost from the restructured entity to the principal.

That is the economic substance of the restructuring transaction. The OECD, the BEPS working groups, and others involved in regulating related-party transactions should consider that when done properly, these business restructuring transactions have as much substance as other transfers of assets and functions – ultimately, all these transfers are about transferring obligations of cash outflows and promises of cash inflows.

In fact, although the effect of fixed costs on the cost of capital is discussed at length in corporate finance textbooks, the same textbooks generally make no reference to a connection between assets, functions, and cost of capital other than through the nature of the costs those assets and functions require for their creation and the systemic risk of the cash flows they result in. It is time for tax professionals to take the quote at the beginning of this article to heart.

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Considering Market Features in Latin America as Part of a Transfer Pricing Analysis

In the context of the various tax and transfer pricing discussions taking place currently internationally, the OECD recently issued a "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles."[21] This article will focus on the analysis of the proposed changes to chapters I-III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), specifically discussing the incidence of the "other market features" in a transfer pricing analysis for companies that operate in Latin America.

Proposed Amendments to Chapters I-III of the OECD Guidelines

In the section on "other local market features," the OECD deepens the discussion (already present in the OECD transfer pricing guidelines available today) of how local market features can potentially affect the transfer pricing analysis through distortions in the comparability between intercompany transactions and transactions with independent parties. Elements to consider include the following:

- The size of the geographic market in which products are sold;
- The purchasing power and product preferences of households in that market;
- Whether the market is expanding or contracting;
- The degree of competition in the market;
- The relative availability of local-country infrastructure;
- The relative availability of a pool of trained or educated workers; and
- Proximity to profitable markets.

Those factors, among others, can generate advantages or disadvantages to doing business in a particular market, which must be considered when performing a transfer pricing analysis. Therefore, the need to make adequate comparability adjustments based on the circumstances of the particular case is established in the revised discussion draft.

[21] OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, (OECD 2013), see http://www.oecd.org/ctp/transfer-pricing/revised-discussion-draft-intangibles.pdf.

To mitigate this significant technical problem, the OECD proposes that taxpayers use, first, comparable information from the local market under analysis, avoiding the need to perform comparability adjustments for these factors, because the comparables (companies, contracts, or prices) used would have the same systemic characteristics as the tested party.

This first theoretical recommendation has serious application issues in Latin American countries. In those markets, available public information is still scarce. This necessarily implies that the number of potentially comparable companies in Latin America is less abundant than in other regions where the capital markets are more robust. In this regard, the revised discussion draft states as follows:

> The need for comparability adjustments related to features of the local market in cases where reasonably reliable local markets cannot be identified may arise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm's length prices of goods transferred or services provided between associated enterprises.[22]

One of the main technical difficulties for transfer pricing practitioners, as well as taxpayers and tax authorities, concerns the lack of practical guidance regarding how transfer pricing comparability adjustments are to be applied. Considering that the differences in the application of these adjustments is a frequent cause of technical disputes between tax authorities and taxpayers, it seems imperative that the new OECD transfer pricing guidelines include a detailed analysis of transfer pricing comparability adjustments that eventually could be performed even in situations when virtually no local comparable companies are available.

Local Market Features in Latin America

As mentioned above, many factors can render two markets not comparable from a transfer pricing perspective. Specifically, Latin America has characteristics significantly different to the rest of the world's regions. Some of these factors, discussed below, are especially significant in light of the major impact they have on Latin American firms.

Volatility and Business Cycles – The OECD transfer pricing guidelines contain scarcely any references to the business cycle as one of the factors that affects comparability in a transfer pricing analysis. Chapter I states that "[t]he existence of a cycle (economic, business or product cycle) is one of the economic circumstances that may affect comparability."[23] Chapter III, paragraph 3.77, regarding the use of multiple-year data when there are cycles, states that "[m]ultiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables,"[24] and then adds that "[d]ifferences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability."[25]

The study of the effect of the evolution of the business cycle[26] on comparability in transfer pricing analysis has not been addressed in the specialized literature in full detail. Moreover, the way in which differences between business cycles in Latin America and those of developed countries affect the transfer pricing analysis of a Latin American firm has barely been considered. This section focuses on analyzing the evolution of the economic cycle in LAC-7[27] countries versus the evolution of the economic cycle in developed economies of G7[28] countries and OECD member countries,[29] and how these differences directly impact transfer pricing analysis when one compares the results of a Latin American company with those of entities that operate primarily in developed economies.

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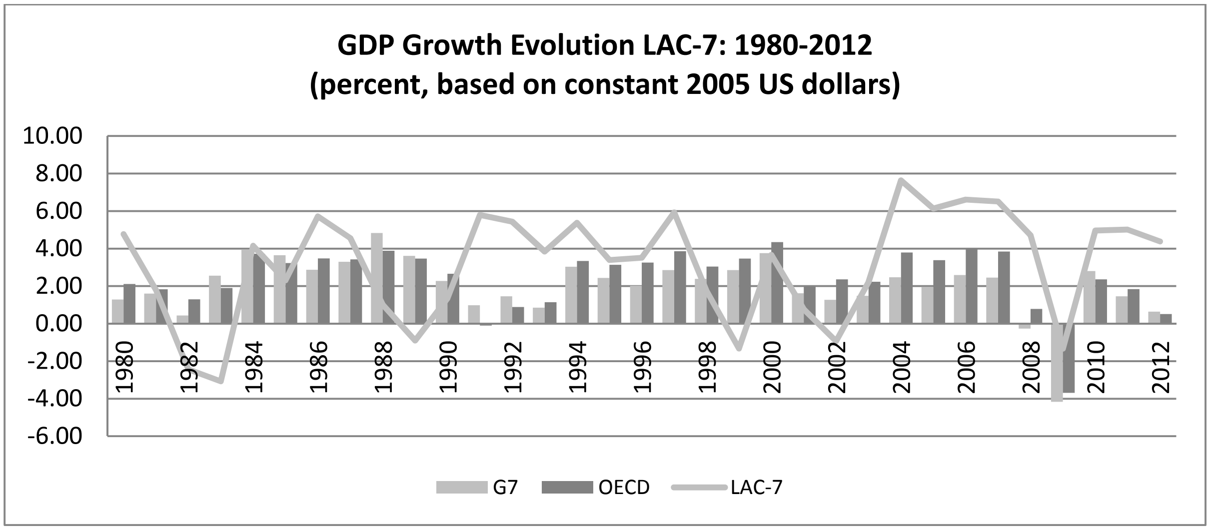
[22] OECD, *supra* n. 1, at 6.
[23] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (*OECD Guidelines*) ch. I, (The Arm's Length Principle), D 1.2.4; 1.56, (OECD 0210), International Organizations' Documentation IBFD.
[24] OECD Guidelines, ch. III (Comparability Analysis); B.5; 3.77.
[25] Id.
[26] In this article, the term "business cycle" is used as a synonym for "economic cycle" according to the specialized economic literature.
[27] The LAC-7, which refers to the seven largest Latin American economies, is comprised of Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
[28] The G7 is comprised of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
[29] For OECD economies, see http://www.oecd.org/general/listofoecdmembercountries-ratificationoftheconventionontheoecd.htm

The dynamic in the economy of the region consisting of the LAC-7 countries is characterized by recurrent oscillations of economic activity, measured by the annual growth rate of the gross domestic product (GDP), as compared to G7 and OECD economies. *See* Figure 1.

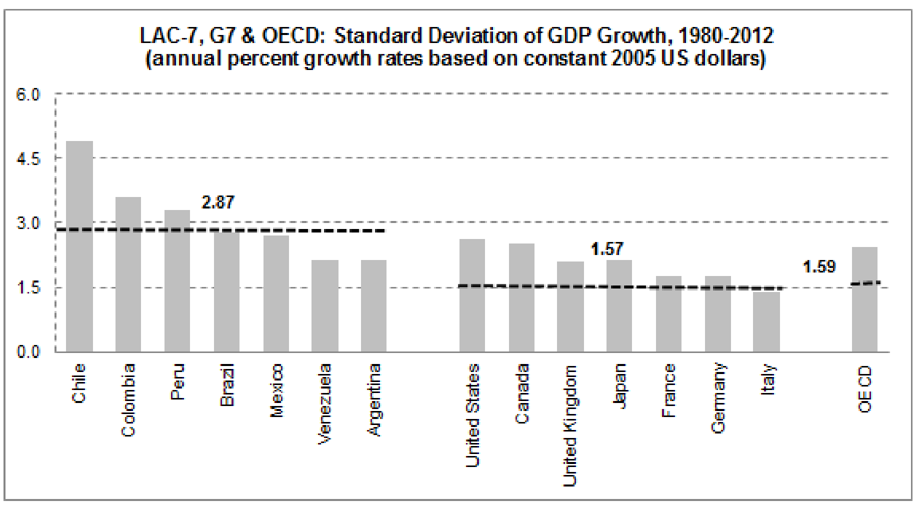
Figure 1*



* Based on World Bank data.
URL: http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

At the same time, as seen in Figure 2, the growth rates of GDP for LAC-7 countries are highly volatile. The average volatility in the growth rates of GDP, measured by the standard deviation, is almost double than in developed countries.

Figure 2*



* Based on World Bank data.
URL: http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

According to the UN Economic Commission for Latin America and the Caribbean (CEPAL) (2009-2010):

> The level of macroeconomic volatility is associated with various elements that differ according to the specifics of each country, but that commonly include issues such as the level of participation in world trade, the productive structure, economic policy, vulnerability to natural disasters, and the institutional framework, among others.[30]

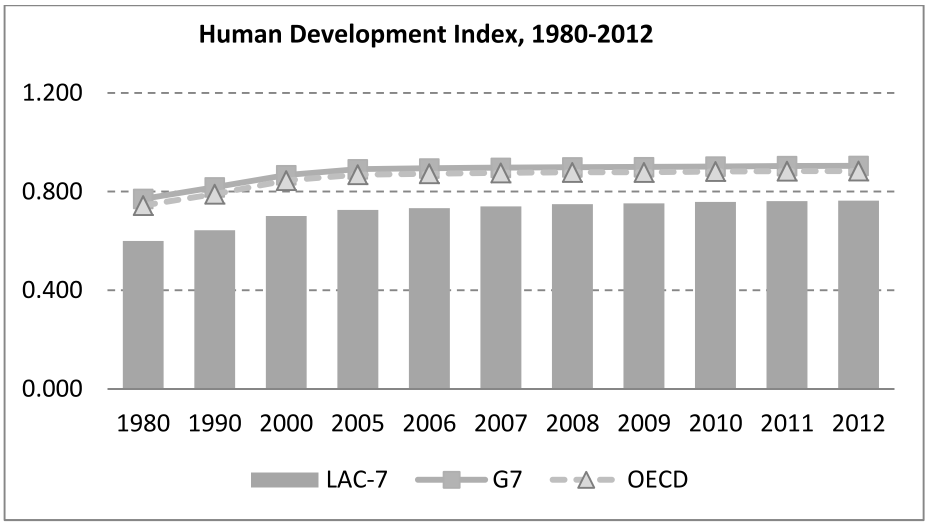
[30] Comisión Económica para América Latina y el Caribe (CEPAL), "Estudio económico de América Latina y el Caribe: 2009-2010", ch. I: "La volatilidad macroeconómica, el empleo y la distribución del ingreso," at 52.

All these elements have an impact on the business cycle of emergent economies and therefore affect the comparability level when performing a transfer pricing analysis.

Human Capital – Related to business cycle volatility, one consequence of the frequent oscillations in emerging economies (relative to developed economies) is the negative impact of lower economic growth on the welfare level of the population. In turn, this lower performance in emerging markets limits the possibilities of appropriate economic development and affects the progress of human capital – the most important factor of production.

Figure 3 shows the human development index (HDI) from 1980 to 2013 of LAC-7 economies vs. developed economies of G7 and OECD countries. The human development index is a compound measure concerning health, education, and income in each country. This graph indicates that in LAC-7 countries, where economic growth rates are highly volatile, the human development index is remarkably lower than the human development index shown for G7 and OECD countries. This relatively poor progress in human capital is expected to affect the productivity of Latin American companies, especially those that are labor intensive, as discussed below.

Figure 3*



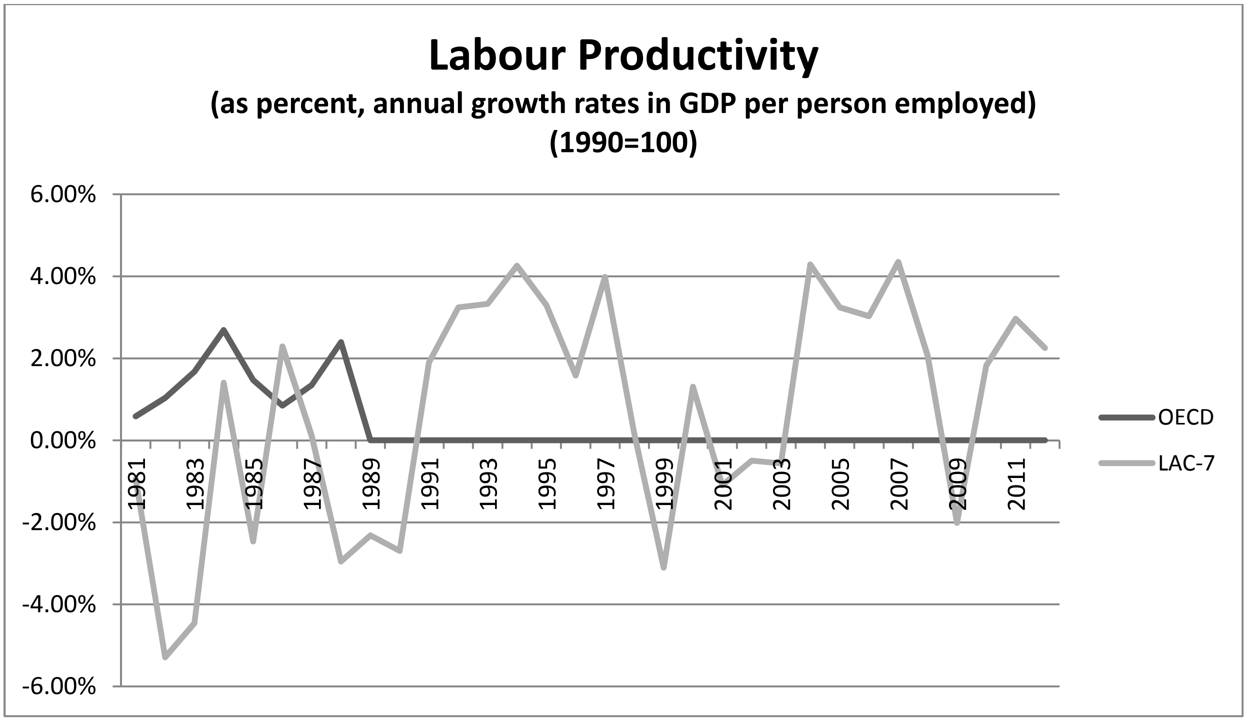
* Based on UN Development Programme for Latin America (*Programa de Naciones Unidas para el Desarrollo*, PNUD) data.
URL: https://data.undp.org/dataset/Human-Development-Index-HDI-value/8ruz-shxu

Productivity – Another significant difference to be considered is labor productivity in Latin American countries vis-à-vis OECD countries. To verify the differences between LAC-7 countries and OECD countries, the analysis here considers the GDP per person employed (1990=100). Data from 1980 to 2012 are used for OECD member countries and LAC-7 countries.

The average of growth rate is 1.58 percent in OECD countries and 0.70 percent in LAC-7 countries; that implies that productivity growth rate in Latin America is less than half that of an OECD country. Obviously, this has huge implications from a corporate profitability perspective.

Figure 4 shows the growth in labor productivity for a range of years, distinguishing between the average in OECD countries and LAC-7 countries.

Figure 4*



* Based on International Labour Organization (ILO) data.
URL: http://www.ilo.org/empelm/what/WCMS_114240/lang--en/index.htm

Ease of Doing Business – A notable aspect of the advantage or disadvantage of performing activities in a particular market concerns the ease of doing business. Relevant variables are revised and ranked in the document "Doing Business," released annually by the World Bank.

The aforementioned ranking takes into account factors such as ease of starting a business, ease of dealing with construction permits, ease of obtaining electricity, ease of registering property, ease of obtaining credit, investor protection, ease of paying taxes, ease of cross-border trading, ease of enforcing contracts, and ease of resolving insolvency.

According to the data studied, it is clear that LAC-7 countries present more difficulties to doing business than OECD countries, with a tendency to even increase the gap between the two groups of countries.

Table 1 indicates that even among Latin American countries there is a heterogeneous situation, with countries of the Pacific Alliance (Chile, Colombia, Mexico, and Peru) in a relatively better position in the World Bank ranking.

Table 1: Ranking ease of doing business*[31]

Economy	Year	
	2012	2013
Argentina	116	124
Brazil	128	130
Chile	33	37
Colombia	44	45
Mexico	53	48
Peru	43	43
Venezuela	179	180
Average OECD	31	31
Germany	18	20
Canada	15	17

[31] Economies are ranked on the ease they provide for doing business, from 1 – 189. A high ranking on the ease of doing business index means the regulatory environment is more conducive to the starting and operation of a local firm

Economy	Year	
	2012	2013
United States	4	4
France	32	34
Italy	75	73
Japan	20	24
United Kingdom	6	7
* Based on World Bank data. URL: http://www.doingbusiness.org/rankings		

Another relevant aspect is cross-border trading, which takes into account factors such as the number of documents required for export and import; time to export and import; and cost of export and import.

Table 2 reveals the differences between OECD and LAC-7 countries. It is clear that LAC-7 countries in general present inefficiencies that make cross-border trade more difficult in the region, thereby generating significant additional expenses for a company that operates in Latin America. The simple facts that the export cost per container is 4.7 times higher in LAC-7 countries than in OECD countries, and that the import cost per container is 6 times higher in LAC-7 countries, clearly show the enormous economic differences that should be considered in a transfer pricing analysis, when one is comparing companies that operate in "different worlds."

Table 2*

	OECD	**LAC-7**
Documents required to export (number)	4	6
Time to export (days)	10	18
Cost to export (USD per container)	369	1,719
Documents required to import (number)	5	7
Time to import (days)	10	25
Cost to import (USD per container)	328	1,980
* Based on World Bank data. URL: http://www.doingbusiness.org/data/exploretopics/trading-across-borders		

The OECD, in its Latin American Economic Outlook 2014,[32] places special emphasis on the above-mentioned disparities, specifically the high logistics costs in Latin America, which lead to inefficiencies and therefore render those countries less competitive than countries in other regions. The logistics performance index (LPI) is mentioned, which takes into account factors such as:

- Efficiency of the clearance process (speed, simplicity, and predictability of formalities) by border control agencies, including customs;
- Quality of trade- and transport-related infrastructure (ports, railroads, roads, information technology);
- ease of arranging competitively priced shipments;
- Competence and quality of logistics services (transport operators, customs brokers);
- Ability to track and trace consignments; and
- Timeliness of shipments in reaching their destination within the scheduled or expected delivery time.

This index reveals that the average LPI Score is 2.96 for LAC-7 countries, while the average in OECD countries is 3.63. A country that improves its LPI grade by a single point will see a positive impact on the average labor productivity of 35 percent. This indicates the importance of not discounting the impact of logistic costs when one compares enterprises in a Latin American country with enterprises that operate outside the region, as logistic costs directly affect development issues, competitiveness, and productivity.

[32] Available at http://dx.doi.org/10.1787/leo-2014-en.

Final Considerations

This article has considered some of the principal systemic differences that can affect any company that operates in Latin America. A sound and in-depth understanding of these differences is necessary when seeking to make comparability adjustments to a Latin American enterprise compared with a firm that operates in a G7 country.

The OECD discussion draft's consideration of the economic advantages and disadvantages of operating in different countries is very valuable, and adds significant elements to comparability analysis issues. However, it is indispensable to delve deeper into the discussion. The next version of the OECD transfer pricing guidelines should include practical suggestions regarding the different kinds of comparability adjustments to be performed in a transfer pricing analysis (with an emphasis on emerging markets).

Because the application of comparability adjustments is a major point of contention between tax authorities and taxpayers, broader guidance on this matter will provide benefits to the major tax actors, reducing the costs of tax audits and the transfer pricing litigation process.

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Australia Issues Draft Rulings and Practice Statements on Transfer Pricing Documentation, Reconstruction

The Australian Taxation Office (ATO) recently released its first guidance on the application of the new transfer pricing rules. Two draft taxation rulings and practice statements were released that detail the ATO's views on its power to reconstruct transactions between related parties, the penalties applicable to transfer pricing adjustments, and transfer pricing documentation requirements.

Draft Taxation Ruling TR 2014/D4 – Transfer Pricing Documentation Requirements – sets out ATO's views on the transfer pricing documentation an entity should prepare and keep as required by section 284-255 of the Taxation Administration Act dealing with penalties.

Draft Practice Statement PSLA 3673 outlines a five-step process for transfer pricing documentation to be followed by tax officers when undertaking a review of a taxpayer's transfer pricing, and is to be read in conjunction with TR 2014/D4.

Draft Taxation Ruling TR 2014/D3 addresses the new reconstruction provision in section 815-130 of the Income Tax Assessment Act 1997, and Draft Practice Statement PSLA 3672 provides guidance on the application of transfer pricing penalites under subdivisions 815-B and 815-C.

Shortly after the guidance was released, Deloitte Australia held a webinar featuring Michael Jenkins, Assistant Commissioner, ATO, and specialist partners from Deloitte's National Transfer Pricing practice. The webinar provided the opportunity to pose a number of questions, and to challenge the ATO's interpretation on:

- Practical changes to existing transfer pricing documentation requirements;
- New steps that public officers must take prior to making tax return declarations;
- Circumstances in which the ATO will seek to ignore transactions put in place by taxpayers and reconstruct their international related-party dealings (including debt/equity structures); and

- How the new penalty rules affect transfer pricing risk management and practice.

Access a recording of the webinar, including the questions raised with the ATO and Jenkins' responses on behalf of the ATO.
URL: http://myvio.tv/Transfer_Pricing_Insights_webinar

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Mexico's Supreme Court rules on expenses incurred from expense sharing agreements with nonresidents

The second chamber of Mexico's Supreme Court issued a decision on 19 March 2014, ruling that expenses incurred on a pro rata basis with nonresidents may be deductible if some requirements are met, despite a provision in the Income Tax Law (ITL) that specifically disallows the deductibility of such expenses.

The case involved a payment made by a Mexican subsidiary to its parent company for the reimbursement of its share of fees paid to international advisors for the acquisition of various international businesses, including a Mexican business.

The relevant provision of the ITL was introduced in 1958, at a time when cross-border transactions were uncommon in Mexico and were difficult to verify and control. In issuing its decision, the Supreme Court looked at the historical and legislative background of the provision, but concluded that, in the current environment, the provision should not be read in isolation. According to the Court, the tax authorities now have many methods at their disposal to validate international transactions, such as tax treaties, exchange of information agreements, and the transfer pricing rules and documentation requirements.

The Court ruled that pro rata expenses incurred with nonresidents will be deductible if the following requirements are met:

- The expenses must be necessary for the company to carry out its activities.
- There must be a justifiable connection between the expenses incurred and the benefit received, or expected to be received, by the company.
- If the expenses were incurred between related parties, the taxpayer must demonstrate that the allocation was agreed on at arm's length terms.
- The taxpayer must provide the Mexican tax authorities with detailed information on the foreign transaction, including:
    - Tax information on the related parties;
    - The activities carried out by each party, as well as its assets and any risks assumed; and
    - The method used to determine the transfer price.
- The taxpayer must maintain supporting documentation on the types of transactions carried out, the contractual terms, the transfer pricing method selected, and comparable transactions or entities for each type of transaction. In essence, these items will be documented by the regular transfer pricing study required under the ITL.
- The taxpayer must maintain documentation that demonstrates that the sharing of expenses was based on objective tax and accounting methods, and was not determined in an arbitrary manner by the company. There must be a valid business purpose for all pro rata expense transactions.

This is an important case in Mexico, and a welcome interpretation by the Supreme Court that is consistent with current international practice. However, the Mexican tax authorities will not necessarily apply the decision automatically, so controversies are likely to arise. Affected taxpayers, therefore, should maintain appropriate documentation to support claims for deductibility of expenses shared with nonresidents.

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Singapore Officials Discuss Transfer Pricing Developments, Upcoming Release of New Documentation Guidelines

Officials from the Inland Revenue Authority of Singapore (IRAS) participated as keynote speakers and panellists in a recent conference organized by the Tax Academy of Singapore titled "*Winds of Change in International Tax Rules – A Singapore Perspective*."

The conference, held 20 May 2014, addressed the latest international tax developments, including the OECD's Base Erosion and Profit Shifting (BEPS) project and its impact on Singapore's tax and investment policies.

The IRAS officials provided key insights on the current level of transfer pricing compliance in Singapore, MAP/APA cases as well as the impending release of new transfer pricing guidelines.

Transfer Pricing Compliance

Based on the cases subject to transfer pricing audit and review, a significant majority (73 percent) of taxpayers did not have contemporaneous transfer pricing documentation.

The IRAS expressed concern that most taxpayers do not comply with the requirements under the Singapore transfer pricing guidelines to maintain contemporaneous documentation, and indicated that new guidelines will be released shortly to address documentation requirements.

Release of New Transfer Pricing Guidelines

The IRAS also announced that it would issue new transfer pricing guidelines on documentation, as well as update the existing guidelines and circulars in 2014.

The timeline for release is as follows:

- New guidelines on transfer pricing documentation to be released for public consultation on September 2014; and
- New or updated guidelines or circulars, including guidelines on transfer pricing documentation to be released on December 2014.

The documentation content requirements are expected to be largely in line with the requirements under the current Singapore and OECD transfer pricing guidelines. In this regard, the master file/local file approach proposed in the OECD discussion draft on transfer pricing documentation is expected to be acceptable and appropriate for Singapore documentation purposes.

As for country-by-country reporting, there appears to be no plan to implement or adopt this requirement in Singapore in the immediate future. We understand the IRAS will continue to monitor OECD and international developments on this matter.

MAP/APA Case Load

The number of mutual agreement procedure (MAP) and advance pricing agreement (APA) cases the IRAS has received in recent years has increased. In 2013, the number of new cases exceeded 25, and the IRAS concluded between 10 and 15 cases in 2013.

The MAP/APA applications involved the following countries:

Australia	Canada	China	France
Germany	India	Indonesia	Israel
Japan	Korea	Luxembourg	Malaysia
Netherlands	Sweden	Thailand	UK

MAP/APA cases have been successfully concluded with the following countries:

Australia	Canada	China
France	Japan	Korea
Netherlands	Taiwan	UK

Observations

In view of the IRAS's findings on transfer pricing compliance, it is anticipated that transfer pricing audit/review activity may be stepped up.

The new or updated transfer pricing guidelines to be released are expected to include more stringent requirements to prepare and maintain contemporaneous transfer pricing documentation. The planned issuance of new guidelines specific to transfer pricing documentation (which is currently addressed in one chapter of the Singapore transfer pricing guidelines) ahead of the other new or updated guidelines/circulars indicates the importance and emphasis the IRAS will place on taxpayers maintaining contemporaneous documentation.

Companies should evaluate their current level of documentation sufficiency, and prepare or conduct an update to ensure that the documentation maintained is contemporaneous and adequate.

Though brief, the profile of the MAP/APA cases released by IRAS is helpful, providing insight into the countries involved, which is a significant consideration for companies considering entering into a MAP or APA. We look forward to the IRAS releasing more detailed information on MAP/APA cases and processes in the future.

We expect the upward trend in MAP/APA requests to continue, an increased interest to be partly attributed to the impending changes from the BEPS initiatives.

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IRS 2013 Competent Authority Statistics Reveal Increase in Demand, More to Come

The Internal Revenue Service on May 21 released competent authority (CA) statistics for the 15-month period from October 1, 2012, to December 31, 2013.[33] The report contains statistics on cases handled by both the IRS Advance Pricing and

[33] The Office of the US Competent Authority (USCA) now tracks its statistics on a calendar-year basis. Thus, the report represents a transition from the historical fiscal-year basis to the calendar year.

Mutual Agreement (APMA) Program and the Treaty Assistance and Interpretation Team (TAIT), and includes information on requests received, cases resolved, and pending cases.[34]

The key trend revealed by the IRS CA statistics is the 22 percent increase in the number of APMA and TAIT cases received by the IRS in 2013.[35] Given the increased foreign and IRS audit activity seen in recent years, and heightened taxpayer awareness and acceptance of the CA process as an effective and practical way to resolve double taxation, this trend is not surprising. In addition, with the recent issuance of Notice 2013-78,[36] the IRS has proposed to allow certain requests for assistance arising from taxpayer-initiated transfer pricing adjustments, which will be helpful to taxpayers that want to address potential foreign transfer pricing adjustments before a foreign audit commences.[37] This expansion of the CA process will likely result in more cases being filed in future years.

Correspondingly, the IRS CA statistics also show a significant increase in closing inventory of both APMA CA cases (30 percent) and TAIT CA cases (23 percent). In addition to the rising number of CA cases received by the IRS, another likely factor in the increased inventory is the current impasse between the U.S. and Indian competent authorities, because U.S. taxpayers continue to file U.S.-India double tax cases, but those cases are not being negotiated or resolved by the two governments. Nevertheless, the IRS is still accepting double tax cases arising from Indian-initiated adjustments and U.S. taxpayers are still required to seek competent authority assistance through the MAP process to:

1. Obtain double tax relief from Indian-initiated adjustments;
2. Take advantage of the memorandum of understanding between the United States and India to stay the demand of Indian domestic tax while the MAP process is pending; and
3. Protect the creditability of Indian tax payments.

Highlights of the 2013 CA statistics include the following:

- While the 2013 statistics show a significant increase in the percentage of transfer pricing cases in which no relief from double taxation was provided (20.2 percent of the cases, measured by the dollar amount of the total adjustments at issue), this percentage is skewed by a small number of cases, as only seven of the total 159 cases resolved in 2013 resulted in no double tax relief. By contrast, in 2012 over 95 percent of the cases resolved (in terms of the dollar value of the adjustments) were settled with full double tax relief, which is more typical of the outcome expected through the U.S. CA process.
- APMA and TAIT resolved an impressive 261 cases in 2013; however, they received a combined total of 403 CA requests. If the number of CA cases received by the IRS continues to rise in the future, the IRS will need to significantly increase staffing levels to keep pace with demand.
- The number of transfer pricing cases received by the IRS related to foreign-initiated adjustments increased in 2013 (218 in 2013 compared with 130 in 2012). This statistic is not surprising given the emphasis the IRS has placed on the need for U.S. taxpayers to protect their foreign tax credit positions by requesting CA assistance in the case of foreign-initiated transfer pricing adjustments. Similarly, the number of non-transfer pricing cases received by the IRS that related to U.S.-initiated cases significantly increased – from 18 in 2012 to 77 in 2013.
- The processing time for transfer pricing double tax cases stayed relatively consistent in 2013 (from an average of 26.0 months in 2012 to 26.1 months in 2013). Non-transfer pricing cases continued to be processed quickly in 2013, with an average processing time of 19.2 months, down from 21.0 in 2012. Notwithstanding these statistics, we understand there are some withholding tax cases in which competent authority negotiations are moving slowly as a result of differences in treaty interpretation between the IRS and some treaty partners.

Overall, the 2013 CA statistics are very positive for U.S. taxpayers. Looking forward, it is anticipated that the number of requests for CA assistance will continue to rise, in light of the foreign and IRS audit environment, the increased emphasis by

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[34] APMA has primary responsibility for cases arising under the business profits and associated enterprises article of U.S. income tax treaties, and TAIT has primary responsibility for cases arising under all other articles of U.S. income tax treaties.
[35] Using annualized data for the 15-month period October 1, 2012, through December 31, 2013.
[36] Notice 2013-78 on requests for competent authority relief would supersede the current Rev. Proc. 2006-54, once finalized.
[37] 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 Mutual Agreement Procedure article of the relevant tax treaty. Under Notice 2013-78, 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.

the IRS on the need to seek CA assistance, and the finalization of the new revenue procedure governing requests for CA assistance, which may expand the scope of CA assistance to taxpayer-initiated transfer pricing adjustments.

As the IRS continues to emphasize the creditability of foreign taxes, U.S. taxpayers under foreign audit should take care not to acquiesce to foreign-initiated adjustments. In addition, U.S. taxpayers that are under tax or transfer pricing audit in foreign jurisdictions, or that have a reasonable expectation they may be subject to a foreign tax audit, should be mindful of treaty timelines to request competent authority relief or notifications, and take all necessary protective measures to preserve their rights to seek competent authority relief. Taxpayers do not need to wait until the conclusion of a transfer pricing audit to take such measures. Failure to notify the IRS (or foreign tax authority) within the specified time frames will likely preclude the taxpayer from seeking competent authority relief from double taxation, which could give rise to issues regarding the creditability of foreign taxes.[38]

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Transfer Pricing and 'High and New Technology Enterprises' in China: What you need to know

The local management of some Chinese subsidiaries of multinational corporations often seeks to qualify the company as a "high and new technology enterprise" (HNTE). HNTE status, which requires ownership of technology by the company, entitles it to the favorable local enterprise income tax rate of 15 percent (versus the standard 25 percent statutory enterprise income tax rate) and a branding impact viewed by the local government as a contribution to the local industry upgrade.

However, the implications of HNTE status could create concerns for the headquarters management regarding the company's global transfer pricing policies. As a result, from time to time we have observed conflicting tension between local management and the company's headquarters on whether the local Chinese entity should apply for HNTE status.

Why. and to what extent, do the conflicts arise? How does a company develop a defendable transfer pricing policy and also take into account the tax incentives offered under HNTE status for companies in China? This article provides a high-level analysis of the above questions by examining the Chinese HNTE conditions and the latest trends in transfer pricing audit practice by the Chinese tax authorities.

Conditions for HNTE Qualification

The Enterprise Income Tax Law grants HNTEs a reduced income tax rate of 15 percent (compared to the statutory rate of 25 percent). Now that some tax holidays have been substantially reduced (for example, the traditional two-year exemption and the three-year half rate incentive have been eliminated), such a tax incentive becomes an appealing tool for a multinational with substantial operations in China. However, an HNTE must meet the criteria set forth below:

- The enterprise must have developed or acquired independent ownership of its *core IP ownership* within the prior three years, when the ownership of core IP rights associated with its core business and/or services;
- At least 30 percent of all employees must be technology personnel holding college diplomas or higher degrees, and at least 10 percent of all employees must be engaged in research and development; and
- The ratio of qualifying R&D expenditures to sales revenue for the enterprise must meet relevant levels for the most recent three financial years (for example, no less than 3 percent for an enterprise with revenue greater than RMB 200 million).

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[38] *See* Procter & Gamble Co. v. U.S., (S.D. Ohio, Case No. 1:08-cv-00608, defendant's motion for summary judgment granted 7/6/10).

Why there are conflicting views between local and HQ management?

The conflicting views of local and headquarters management on applying for HNTE status may arise initially from the different priorities and goals of financial and tax management. Local management is often attracted by the lower income tax rate, the prestigious HNTE status, and the prospect of maintaining a good relationship with the local government. The headquarters management, conversely, may be more concerned about the potential implications to the multinational's global transfer pricing policy and the global effective tax rate.

Local governments tend to encourage enterprises to apply for HNTE status, because the number of HNTEs in a given area may be used as an indicator of local economic development. local management usually prefers to maintain a good relationship with local governmental authorities because they may play an important role in approving various business applications.

HNTE status could also help the company build up its image with customers and other stakeholders as an owner of advanced technology.

However, HNTE status (in particular, the core IP ownership) may potentially affect the characterization of the local company under the group's global arrangement.

	Local Chinese Management	HQ Management
Good relationship with local government	Significantly concerned	Less concerned than local management
Honorable status	Significantly concerned	Less concerned than local management
Reduced local income tax rate	Significantly concerned	Local income tax rate is only one of the factors affecting the global effective tax rate
Global TP policy	Less concerned	Significantly concerned

Because of the benefits from HNTE status mentioned above, local Chinese management is often motivated to move forward with the necessary organizational changes and documentation preparation to qualify for HNTE status. However, in practice, the application for HNTE status is not a clear-cut exercise, and could potentially generate ambiguity.

For example, for the core IP ownership:

- Circular 172 stipulates that core IP rights refer to specific IP that is registered by a Chinese enterprise. Circular 362 provides additional guidance on core IP, whereby core IP includes inventions, new models, new appearance designs that are not a mere change in pattern and shape, software copyrights, patents of integrated circuit design, and new plant species.
- At first glance, the requirement appears to mean that know-how and other non-registerable IP may not be recognized during the application process evaluation of the primary requirements. Technical know-how, however, will be recognized in the secondary requirement's index for "capability of technology result transformation" within the scorecard system during the HNTE application.
- To maximize the chance of qualification, local management tends to state in the application documentation that the IP owned is "core" technology, even though it may not be core technology from a global group perspective. For example, a manufacturing process that may qualify as a local patent (and thus could be considered "core IP" for purposes of the HNTE application) may not necessarily be as valuable as the foundation technology owned by its global affiliate.

In addition to the core IP requirement, other parts of the HNTE qualification require judgment calls and thus could lead to potential ambiguity, including the qualified personnel/R&D projects, R&D expense composition, and the calculation of qualified revenue.

Given the ambiguity of the HNTE qualification standards and the discretionary power of the government agencies involved in the review process, it is possible that a company could obtain HNTE status, and be deemed to own the core IP for purposes of HNTE qualification, but may not own the core IP from a group transfer pricing arrangement standpoint. From a group perspective, the China entity may still be positioned as a routine company without nonroutine IP; hence, the global transfer pricing policy may reward the Chinese entity based on a routine profitability, which is normally determined based on a transactional net margin method (TNMM) benchmarking against routine comparables without nonroutine IP.

However, when the anti-avoidance department of the Chinese tax authorities examines the HNTE's transfer pricing compliance (at a later time after the HNTE application[39]), the routine entity characterization and HNTE status could potentially cause serious challenges to the group's transfer pricing policy.

The OECD transfer pricing guidelines make it clear that the TNMM may be applicable only when the tested party, as the less complex party to the transaction, makes no unique contribution.[40] As the value of unique IP may not be easily identified and there may not be ideally comparable IP owned by the comparable companies, normally TNMM would capture only the return of routine functions and risks, but not the return for unique IP.

Chinese transfer pricing regulations, like the OECD transfer pricing guidelines, indicate that the use of a transfer pricing method should take into account the functions, risks, and assets assumed in the transactions, and China's State Administration of Taxation mentioned the study of IP as a focus in its annual anti-avoidance reports in recent years.

As provided in the UN's Transfer Pricing Practical Manual for Developing Countries, the SAT thinks that over time the local entity "acquires the skill and experience from operations in China, and may even contribute to the improvement of the MNE's original intangibles."[41] In general, local tax authorities often hold the view that in return for the preferential HNTE treatment, the taxpayer should earn a profit margin higher than a routine margin.

Senior SAT tax officers have mentioned in public that a company with HNTE status should not be considered a cost-plus entity in its related-party transactions. We have also seen cases whereby the local tax authorities disallowed the deduction of royalty payments from an HNTE to its overseas affiliate, arguing that the HNTE is supposed to own the core IP and should not pay technology royalty.

On the other hand, headquarters management must maintain global consistency regarding the group's transfer pricing policies, and it might be concerned about the impact on the global business model if a local subsidiary is considered the core IP owner. Naturally, headquarters might be hesitant about any potential "deemed" change of a subsidiary's functional and risk profile, and the potential associated challenges. Because of the potential ambiguity of the HNTE application and potential uncertainties, headquarters management is usually unwilling to proceed with the HNTE application, which local management may not always fully understand.

Developing a Defensible Transfer Pricing Policy and Taking Advantage of HNTE Status

In principle, a company's transfer pricing policy should be based on the facts and a thorough functional and risk analysis. When assessing the economic ownership of IP, special attention should be paid to whether evidence or analyses support the assertion that the local entity in fact contributes to the group core R&D. Taxpayers must balance the local HNTE benefits with the potential transfer pricing exposure.

If the local entity does indeed contribute to the group core R&D, the taxpayer should consider adopting a transfer pricing policy that allocates a proper return to the local entity, and apply for HNTE status to take advantage of the preferential tax treatment.[42] In that situation, regardless of whether the company secures HNTE status, the local entity possibly would be expected to earn a higher return than a TNMM routine return. Of course, the increased attention from the tax authorities due to the local contribution on IP necessitates a careful review of the documents such as the HNTE submission documents (which should not overstate the importance and role of the local R&D activities and IP) and its alignment with the group's transfer pricing policy.

If local involvement in R&D is more routine than core R&D (if, for example, the comparable companies are engaged in similar activities), the taxpayer should not proceed with the HNTE application, regardless of its likelihood of success in the application process, because of the ambiguity of the conditions for HNTE status. While the possibility that an entity may

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[39] In China, the statute of limitation for transfer pricing audits is 10 years.

[40] OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, Para 2.4 and 2.59.

[41] UN's Transfer Pricing Practical Manual for Developing Countries, Chapter 10.2, "China Country Practices."

[42] In addition, a separate benefit of HNTE status is that qualified local R&D expenses could be entitled to a 50 percent super-deduction.

qualify for HNTE status and also avoid any contradictions of the global functional and risk allocation cannot be ruled out, special care would need to be taken to mitigate the risk to the global transfer pricing arrangement.

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Malaysia Amends Income Tax Return, Adding Question on Transfer Pricing Documentation

Malaysia's Inland Revenue Board recently made changes to the disclosure requirements in Form C – the income tax return – for year of assessment 2014 that mandate the preparation of transfer pricing documentation before the filing deadline.

Changes to Form C

The revised Form C for YA 2014 includes a new item requiring that the taxpayer indicate whether transfer pricing documentation has been prepared for the relevant year of assessment.

R4 Transfer Pricing Documentation prepared:
(Enter X in the relevant box) Yes ☐ No ☐

Existing Provisions

In Malaysia, Section 140A of the Income Tax Act 1967, read together with the Income Tax (Transfer Pricing) Rules 2012 and the Malaysia Transfer Pricing Guidelines 2012 issued in July 2012, requires all companies that engage in transactions with associated persons to determine and apply the arm's length price for those transactions. Further, the transfer pricing rules and the transfer pricing guidelines require a person who enters into a controlled transaction to prepare contemporaneous transfer pricing documentation for the year in which the controlled transaction took place.

The transfer pricing rules and guidelines clearly spell out the meaning of the term "contemporaneous transfer pricing documentation" as follows:

"Contemporaneous transfer pricing documentation" means transfer pricing documentation which is brought into existence:

When a person is *developing or implementing* any controlled transaction; and
Where in a basis period for a year of assessment the controlled transaction is reviewed and there are *material changes*, the documentation shall be updated *prior to the due date* for furnishing a return for that basis period for that year of assessment.

Implications of Changes

Under the existing regulations, the taxpayer is required to maintain contemporaneous documentation for years in which there are controlled transactions. The law clearly specifies that in the event material changes occur, the deadline for updating the documentation is before the due date for filing the income tax return.

The introduction of the new item in Form C regarding the disclosure of transfer pricing documentation clearly impresses upon taxpayers that, from YA 2014 onwards, it is mandatory for all taxpayers that fall within the purview of the guidelines to prepare and maintain transfer pricing documentation before the due date for filing the return (irrespective of whether or not there were material changes).This means that for YA 2014, the taxpayer would need to have transfer pricing documentation in place before the filing deadline to be able to check "YES" to Item R4 in Form C.

Timeline

Year end	Filing deadline for Form C	Deadline to prepare TP Documentation
January 2014	31 August 2014	31 August 2014
March 2014	31 October 2014	31 October 2014
December 2014	31 July 2015	31 July 2015

In the wake of this amendment, taxpayers may face some questions, such as:

- If the taxpayer has prepared documentation up to YA 2012, may it respond "Yes" to Item R4?
- If the taxpayer's turnover and related-party transactions are below the thresholds set in the transfer pricing guidelines, may the taxpayer respond to Item R4 with a "No"?
- According to the transfer pricing rules and guidelines, a taxpayer is required to update its transfer pricing documentation only if there are "material changes." If the taxpayer had prepared documentation for a prior year of assessment, and there has been no change in the taxpayer's functional and risk profiles, may the taxpayer respond "Yes" to Item R4?
- What are the implications of responding "No" in Item R4?
- Would the taxpayer be subject to penalties for noncompliance?

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