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China’s SAT Releases New Bulletin to Strengthen Transfer Pricing Administration on Intragroup Outbound Charges

China’s State Administration of Taxation (SAT) on 18 March released a bulletin that formalizes several previously announced positions for dealing with service fees and royalties paid to overseas related parties. The new measures deny income tax deductions for some service fees and royalties paid by Chinese companies to foreign affiliates.

The Bulletin on Enterprise Income Tax Issues concerning Outbound Payments to Overseas Related Parties is intended to reaffirm basic principles and clarify administrative requirements for intragroup outbound charges, and is one of China’s initiatives to align with global efforts to combat tax avoidance.

Background

The SAT has been paying special attention to offshore intragroup service fees and royalties since 2012. After several preliminary measures in 2014, the SAT has now taken the significant step of formalizing its position.
At least some elements of Bulletin 16 can be seen as a Chinese effort to implement parts of the Base Erosion and Profit Shifting (BEPS) action plan domestically, in addition to previous announcements introducing the new general anti-avoidance rule (GAAR) procedures and promulgation of new regulations on indirect equity transfer.

**Highlights of Bulletin 16**

Bulletin 16 reaffirms the arm’s length principle for intragroup service fees and royalties – a positive move. There is also a clear emphasis on substantiating the authenticity and arm’s length nature of service and royalty transactions with intercompany agreements and other supporting information.

Based on different features of service fees and royalties, the Bulletin illustrates four types of intragroup payments that are not in compliance with the arm’s length principle and are not deductible for Enterprise Income Tax purposes:
Observations

Bulletin 16 has formalized positions that the Chinese tax authorities have been taking for several years. Furthermore, as China’s participation in BEPS initiatives continues, we expect there will be additional announcements to incorporate BEPS actions into domestic Chinese regulations. In addition to the specific rules regarding nondeductibility of service fees and royalties, there are a number of guiding principles that are addressed in more detail below.

Nondeductibility vs. special tax adjustment

With Bulletin 16, the Chinese tax authorities have taken a clear position that service fees and royalties may not be deductible for tax purposes under certain circumstances, which tax practitioners regard as a major development. The move raises questions regarding the legal grounds for the Bulletin, because Bulletin 16 refers to Article 41 of the Enterprise Income Tax Law (EIT Law) regarding “special tax adjustment” instead of Article on “nondeductibility,”
which could imply that the real legislative intention did not include “nondeductibility.”1 A practical issue arises because transfer pricing investigations usually result in adjustments based on the arm’s length principle, not outright denial of deductions. However, given some of the comments in the OECD’s BEPS initiatives, a tax authority could possibly satisfy the arm’s length principle by entirely disregarding transactions – as contemplated by “nonrecognition” treatment in BEPS.2

There are potential issues around double taxation in these circumstances if the foreign tax authorities consider the fees to be income, irrespective of whether the Chinese tax authorities allow the deductions. The Chinese tax authorities have already denied deductibility in recent cases. Taxpayers need to manage this risk by being proactive in self-review of transactions before they are paid to mitigate the risk of having the payments deemed nondeductible.

There are also different interpretations on some practical issues. For example, it is unclear whether the nondeductible treatment of a specific payment should be reflected on the annual tax filing as a regular upward adjustment item to taxable income or whether it should be subject to tax adjustment during a transfer pricing audit (requiring SAT approval). Further, it is not clear whether Mutual Agreement Procedures (MAP) could apply to resolve the double taxation issue once “nondeductible” treatment is made against a PRC entity. How the SAT will apply the new rules remains to be seen, although there are concerns about how the more aggressive tax bureaus may apply the rules.

**Benefit Test on Service Fee**

The SAT has at last formally introduced the benefit test to analyze the reasonableness of service fees, which has long been the OECD and international approach for service fees. The language being used is consistent with the OECD’s comments in BEPS Action 10 regarding intragroup services, stating that a benefit test will be performed to evaluate whether “the activity provides to a respective group member with economic or commercial value to enhance or maintain its commercial position….“3

An effect of introducing the benefit test will be to change the focus of service fee reviews. For a long time, when examining service fees, some tax authorities paid more attention to the mark-up rate – as long as the mark-up rate was not too high, the service fee payment would not be

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1 Article 8 of the Enterprise Income Tax Law stipulates that “reasonable expenses actually incurred by an enterprise in connection with the earning of revenue, including costs, expenses, taxes, losses and other expenses, are deductible in arriving at taxable income for enterprise income tax purposes.” Article 41 of the Enterprise Income Tax Law stipulates that “If a business transaction between an enterprise and its related parties does not comply with the arm’s length principle, thus reducing the taxable income or revenue of the enterprise or the related parties, the tax authorities shall be empowered to make adjustments using reasonable methods.”

2 BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Re-characterization, and Special Measures, OECD, December 2014.

challenged. But in applying the benefit test, the tax authorities’ focus will clearly extend to the substance and chargeability of the service fee itself. If the service fails to pass the benefit test, regardless of the mark-up rate, the service fee could be totally disallowed for income tax deduction. Given the sometimes subjective nature of service fee charges, this may lead to more disputes involving previously straightforward transactions.

The Bulletin has also formalized the “six tests” introduced and elaborated by the SAT in a comment letter submitted to the United Nations in 2014, although some controversial aspects have not been carried over. The following recap of the issues raised by the SAT for the six tests in the comment letter is helpful to better understand Bulletin 16.

**Benefit test:** In the comment letter, the SAT approached the benefit test from the perspectives of both the service recipient and the provider. It could be inferred that, in the SAT’s view, service fees will not be charged if the benefit is incidental.

Article 4 of Bulletin 16 confirms that view, treating payments for “incidental” benefits as “nondeductible.” This is aligned with the current OECD view on services that is coming out of BEPS.

Article 6 also denies the deductibility of royalty payments to overseas related parties for “incidental benefits” derived from the financing and listing of the holding company – i.e., when the listed company charges its subsidiaries for a perceived reputational gain from being publically listed. There have been some cases in which the Chinese tax authorities challenged the deductibility of royalty payments to the overseas listed company that claimed the listing of the group enhanced the reputation of the Chinese subsidiaries.

**Necessity test:** The SAT advocated that consideration should also be given to whether the services are needed by the subsidiary. For example, the SAT stated that a manufacturing subsidiary might not need high-end intragroup services like consulting or legal services, due to its functional profile. However, it is accepted that if the manufacturing subsidiary had a complicated function and risk profile and was in need of services, it may be willing to engage
an independent entity to provide those services or perform them in-house. This position is somewhat unorthodox, as even limited-function entities will sometimes need so called “high-end” services.

**Value creation test:** According to the comment letter, services create value when they are able to bring in identifiable enhancements of economic and business value, improving the service recipient’s operating performance.

Of particular concern to the SAT are service payments to parent companies just for providing authorization services to the local country management. The SAT believes these are simply management services that serve as a procedure rather than creating identifiable economic or commercial values. Therefore, they should not be charged.

**Duplication test:** The SAT considers that many management services (such as those illustrated in the value creation test) are likely to be duplicative activities or shareholder activities, and therefore should not be charged. This test also appears in a BEPS discussion draft issued by the OECD: "no intragroup service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party."^4

**Remuneration test:** In the comment letter, the SAT pointed out that in analyzing intragroup services, consideration should be given to whether the provision of various services has already been remunerated through other related-party transactions.

For example, the comment letter discussed a situation whereby a subsidiary purchases raw materials from its parent company and resells the finished goods back to the parent. In that situation, the SAT explained, the parent company is the ultimate beneficiary of the centralized procurement (through a lower finished goods price) and it is not appropriate to charge a procurement service fee to the subsidiary.

**Authenticity test:** In the comment letter, the SAT outlined its concern that it is difficult to verify the authenticity of intragroup services. Now, under Bulletin 16, the in-charge tax authority has the right to request relevant documents to substantiate the authenticity and arm’s length nature of a service transaction. This may be a challenge for enterprises that do not have the relevant information and documentation prepared and filed in advance, and it may be an extra hurdle for many taxpayers in China.

**Value Creation and Contribution Test on Royalty Payments**

Bulletin 16 goes further in aligning with the BEPS actions in the explanatory notes. The notes state that when determining the arm’s length nature of a royalty payment, it is necessary to analyze the functions performed, risks assumed, and assets used in the development, enhancement, maintenance, protection, and exploitation of the intangibles by each of the related parties. This will determine which entity or entities made contributions to the value of the intangibles and the parties that should be entitled to a return derived from the use of the intangibles.

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intangibles. This is a clear reflection of the OECD transfer pricing guidelines on intangibles released in September 2014 as a deliverable of the BEPS Action Plan.

Taxpayers will need to provide clear evidence of the contribution of the overseas related parties to the intangible property development. There is also an expectation that Chinese contributions are identified, entitling the China entity to the intangible returns and reducing any outbound royalty rates. Although the SAT has not provided guidance on how it wants the contribution analysis to be performed, it will likely refer to the OECD’s transfer pricing guidelines at the conclusion of the BEPS project.

In the past, the tax authorities have challenged royalty payments made by loss-making companies. With the release of Bulletin 16, loss-making companies paying royalties to overseas related parties will face more stringent challenges from the tax authorities, and will have more difficulties in justifying the value of IP.

The Bulletin denies the deductibility of royalties paid to overseas entities that merely possess legal ownership but have failed to contribute to the intangible – an approach that is consistent with the OECD’s current thinking. This will increase the difficulty of having a licensor incorporated in a tax haven own intangible property (IP) and charge royalties to a Chinese licensee. There is also no comment on how sublicensing may be addressed.

The SAT’s explanatory notes include an example to illustrate the nondeductibility of a royalty payment. It is focused on IP in connection with real estate development that is licensed by an overseas related party. The SAT states that if the relevant trademark or brand name obtains market recognition through the domestic entity’s operations, and the maintenance, promotion, and value enhancement of the intangible are the responsibility of the domestic entity, then the royalty paid to the overseas related party by the domestic taxpayer is not deductible.

In reality, apart from the relatively unique circumstances of the real estate industry, it is common for brands to be well known in foreign markets, but have limited brand recognition in China. If all or most of the Chinese or global brand enhancement and promotion have been carried out by the Chinese entity – notwithstanding global efforts, the Chinese tax authorities will expect the PRC entity to be remunerated for its contribution. In an extreme case, if an overseas IP holding company undertakes no functions or risk, the tax authority is likely to recharacterize the whole royalty arrangement. This approach is already being followed in China – in a recently reported case in Chengdu, the tax authority disallowed all royalties paid to an IP holding company registered in the British Virgin Islands, on the basis that the China entity made almost all the contributions to the value of the intangible.

Burden of Proof

Bulletin 16 and its interpretation make it clear that there is no need to get pre-approvals from the tax authorities for overseas remittances of service charges or royalties. However, upon request by the tax authorities, the taxpayer is required to submit the intercompany agreements and other supporting evidence to substantiate the authenticity and arm’s length nature of the transaction. There is a clear emphasis on being able to prove the authenticity of the service being provided, something that can be difficult for certain types of services. The tax authorities will have the right to perform a tax adjustment on any noncompliant transactions within a
period of 10 years; thus, evidence of services should be maintained contemporaneously, as it is unlikely to be available 10 years later.

**Tax Authorities’ New Angles in Examination**

**High profit is no longer safe harbor for transfer pricing audit:** It is generally accepted that a loss-making or low-profit enterprise is vulnerable to transfer pricing audit. However, in a recently published case concluded in Guangzhou, the tax authorities tried to move away from their traditional approach to target selection and review. Their attention has been extended to highly profitable companies, and they have identified fees for service transactions paid to overseas related parties that were obscured by high profits. Through investigation, deductions for some service fees were disallowed, and adjustments were made to other significant service fees.

**Payment to tax havens/low-tax jurisdictions:** Bulletin 16 denies the deductibility of payments to overseas related parties that do not assume functions and risks or have economic substance. Service charges and royalty fees flowing out to tax havens and low-tax jurisdictions are usually easy targets for the tax authorities’ examination. Due to the low effective tax rate in those jurisdictions, multinational groups have had the motivation to transfer profits to these locations through service charges and royalties. However, the actual functions are seldom carried out by the entities within these jurisdictions, leading to a mismatch between profit allocations and function and risk profile. This kind of arrangement has been and will be more vulnerable to tax authorities’ challenges as time goes on. Actions have already been taken – for example, when Circular 146 was released, the tax authorities in Beijing launched a special examination of service charges/royalties paid to a list of tax havens and low-tax jurisdictions, including 40 countries/regions.

**Suggestions**

Through Circular 146 and the following nationwide scrutiny, the tax authorities have collected a significant amount of information for target selection and transfer pricing audits. The release of Bulletin 16 has provided the tax authorities with a solid legal basis for the specific positions they had announced, and the local tax authorities are expected to take follow-up actions. In this changing legislative environment, and following the tax authorities’ tightening focus on intragroup services charges and royalties, taxpayers should pay specific attention to the associated transfer pricing risks and take proactive action to prepare for possible inquiries and challenges from the tax authorities. In particular, the following measures are recommended:

- Prepare supporting information for intragroup services and royalty transactions, including the transaction flow, legal documents, transaction amounts, and pricing policy.
- Analyze the substance, need for, and reasonableness of the service fees and royalty payments based on business needs and economic substance, including:
  - Business needs when the transactions were implemented, and the continuing requirement
  - Examine the economic substance of each type of service fee and identify any areas of potential duplication
  - Review the group pricing policy and the reasons for any changes over time.
• Review the legal and economic ownership of intangibles, and prepare relevant supporting documents to substantiate the contribution of value creation to the intangibles.
• Communicate with the central finance and tax departments in the group, and request information, assistance, and integrated solutions at the group level. Dealing with these issues requires open collaboration between the local company and the parent company.
• Provide training for management and operational leaders on basic transfer pricing requirements to help identify issues early, and ensure there are internal transfer pricing guidelines to manage new and changing transactions.

The new regulation and measures will force taxpayers to focus on intercompany service charges and royalties. There are potentially large tax exposures in China if a tax adjustment is performed or entire service fees are treated as nondeductible.

The classic way of mitigating transfer pricing risk by preparing contemporaneous documentation or ensuring that profitability falls within a reasonable range may no longer be appropriate. This is no longer enough. Taxpayers need to be more proactive in adapting to the new environment and manage their tax risks in the future.

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2014 US APA Report Shows Program Holding Steady

The Internal Revenue Service on March 30, 2015, released Announcement 2015-11, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2014. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a brief summary of recent developments in the APMA Program and a statistical snapshot of the program's activities during 2014.

Unlike the 2013 annual report, which highlighted improved efficiencies, the 2014 annual report suggests the APMA Program was generally able to hold onto efficiencies from the prior year but was unable to make further improvements. During 2014, there were significant changes in the management of the IRS LB&I transfer pricing leadership, which may have hindered further efficiency improvements.
As countries adopt and companies seek to comply with recent Organization for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) initiatives, including country-by-country reporting, as early as 2016, APAs are expected to play an important role in transfer pricing risk management. The IRS is also expected to release an update to the APA Rev. Proc. 2006-9 this year.

Statistical highlights of the APA annual report include:

- **Decrease in completed APAs:** During the 2014 calendar year, APMA closed 101 APAs (20 unilateral, 81 bilateral, and no multilateral), compared to a record 145 APAs in 2013 and 140 APAs in 2012. Renewal APAs represented 48 of the 101 APAs executed, with 9 unilateral and 39 bilateral renewals. As in the prior year, renewals represented about half of all completed APAs.

- **Months to complete APAs:** In 2014, the median time to complete a unilateral APA was 30 months, and 35 months for a bilateral APA. In 2013, the median times to complete unilateral and bilateral APAs were 28 months and 37 months, respectively. Overall, the median time required to complete the 101 APAs executed in 2014 was 35 months, approximately two months longer than in 2013, indicating that APMA was able to maintain efficiency gains from the past two years but unable to further improve on those gains. Taxpayers renewing bilateral APAs benefitted from faster processing times for their APA requests – a median of 33.9 months-- compared to the median processing time for new bilateral APA requests – 45.1 months. Inexplicably, renewals of unilateral APAs took 15 months longer than new unilateral APA applications (40.9 months compared to 26 months, based on median processing times).

- **New cases:** The IRS received 108 APA applications (31 unilateral, 74 bilateral, and 3 multilateral) in 2014, a slight decrease from the 111 APA applications received in 2013. While Japan and Canada continue to account for the largest share of bilateral APA requests, APA requests involving other countries have become a significant part of APMA’s inventory. Notably, APAs involving the United Kingdom and Korea represented 10 percent and 8 percent of APA requests, respectively; Denmark, Mexico, and the Netherlands each had a 5 percent share. The IRS announced recently that it would start accepting prefiling conferences for APA requests involving India, which the IRS had previously refused to do as a result of the large number of unresolved double tax cases with India. Accordingly, bilateral US-India APA requests are expected to be a significant source of new APA requests in 2015.

- **APA inventory:** The APMA Program had 336 cases in active inventory at the end of 2014: 62 unilateral APAs, 268 bilateral APAs, and 6 multilateral APAs. In comparison, active inventory was about the same at the end of 2013, with 331 cases. Thus, the APMA Program in 2014 was closing cases about as fast as new requests were coming in. APMA and the taxpayer community had hoped further efficiencies would be realized from the streamlining of the APMA Program’s internal processes to reduce the number of pending APA requests. APMA’s efficiencies in completing cases may also likely reflect that less complex cases are being processed in a timely manner with more complex cases remaining in the active inventory for a longer period.

- **Term length of APAs:** Of the APAs executed in 2014, 41 cases had a five-year term, while more than half had terms of six years or longer. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a
rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.

- **Staffing:** The APMA Program is currently comprised of 59 team leaders, 22 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to the prior year, this represents an increase of four team leaders and a decrease of four economists. The reduction in the number of economists may be a cause for concern. In the past, lack of economist resources delayed APA case processing; under the new APMA Program management, economists are taking an increased role in negotiating bilateral APAs with treaty partners. The team leader groups are organized by country, with each group having responsibility for multiple countries.

- **Cancellations, revocations and withdrawals:** No APAs were cancelled or revoked during 2014. One APAs request was withdrawn in 2014.

- **Inbound v outbound:** As in 2013, inbound cases continued to account for the majority of the APMA Program’s caseload in 2014, with 55 percent of the APAs executed involving foreign multinationals with US subsidiaries. Significantly, APAs involving US multinationals and their non-US branches, likely financial institutions for the most part, constituted 8 percent of APAs executed.

- **APAs executed by industry:** In 2014, manufacturing and wholesale/retail trade accounted for 48 percent and 22 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (64 percent of such cases). Meanwhile, the computer and electronic products segment was largest among manufacturers (27 percent of such cases).

- **Covered transactions and transfer pricing methods:** Thirty-six percent of the transactions covered in APAs executed in 2013 involved the sale of tangible goods, and 40 percent involved the provision of services. As in 2013, the comparable profits method (CPM) was used to evaluate approximately 78 percent of the transactions involving tangible and intangible property in 2014. Of those property transactions, approximately 88 percent used the operating margin as the profit level indicator (PLI). For services transactions, the most frequently applied methods were the CPM (77 percent of cases) and the services cost method (17 percent of cases). Of those services transactions applying the CPM, 47 percent used operating margin as the PLI and 45 percent used return on total costs.

- **Sources of comparables:** The IRS expanded the breadth of databases used to identify comparables, particularly comparable license agreements and financial transactions. Newly identified sources include RoyaltyStat, RoyaltySource, ktMINE, LoanConnector, Bloomberg, and Recap.

- **Adjustment mechanisms:** The majority of the transactions covered in APAs executed in 2014 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to tested-party results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2014 executed APAs include an adjustment bringing the tested party’s results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to
the specified point or royalty rate, and an adjustment to the median of the range for a single year.

- **Boilerplate and APMA program contact information**: The annual report also includes the latest version of the APMA Program’s boilerplate APA agreement (the Model APA) and a list of primary APMA Program contacts. Efforts are currently underway to revise the Model APA for the first time since 2009.

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**Progress on Competent Authority Cases Results in IRS Acceptance of APA Prefiling Conferences for Bilateral US-India APAs**

The IRS on March 11 announced on its website that the Advance Pricing and Mutual Agreement program will begin accepting requests for prefiling conferences for bilateral APAs between India and the United States. This announcement is the direct result of substantial progress made by the US and India on competent authority negotiations following the January 2015 agreement on a framework to resolve information technology-enabled services (ITeS) and software development cases.


The timing of the announcement allows taxpayers that are planning to file unilateral India APA requests before the March 31, 2015, deadline to begin the process of converting their requests into bilateral APA requests.

The IRS specified that it is accepting only applications for prefiling conferences, rather than for bilateral APAs.

The announcement confirms a statement made to reporters on March 6 by David Varley, acting director of the IRS’s Transfer Pricing Operations that the IRS was ready to begin discussions with taxpayers interested in US-India bilateral APAs. Both Bloomberg/BNA and Tax Analysts reported Varley’s announcement that, even though the IRS was not yet accepting actual applications for bilateral APAs, it would begin accepting requests for prefiling conferences, and that conferences may take place as early as the week of March 23. Varley said that enough progress has been made in resolving the backlog of double tax cases with India that “we believed that the time was right to start the process for the bilateral APAs, and of course the first step in that process will be these prefiling conferences.”

To request a prefiling conference, taxpayers must fill out a questionnaire provided on the IRS website. In addition to answering all questions in the application for a prefiling conference, taxpayers will be expected to provide the following additional information:
• For taxpayers that have already filed a unilateral APA application with India and who may now be seeking to convert that application to a US-India bilateral APA application, taxpayers should (i) in advance of the meeting, provide APMA with a disk containing a .pdf electronic copy of their unilateral APA application and any materials submitted to India in relation to the unilateral APA request; and (ii) be prepared to discuss the content of their unilateral request and the status of their request and discussions with the Indian APA office;

• For taxpayers proposing an APA with covered transaction(s) involving an Indian-resident affiliate performing ITeS or software development services, in particular, taxpayers should, in advance of the meeting, provide APMA with a disk containing (i) a .pdf electronic copy of the Indian affiliate’s organization chart, broken down by functional and administrative departments; and (ii) an Excel file with the financial information that has either been provided in relation to a pending Indian unilateral APA application or financial statements that have the following elements, as appropriate to the transactions proposed to be covered:

  o Segmentation of each tested service provider’s income statement between ITeS services, SWD services, and/or any other services or activities that are performed by each tested service provider;

  o Historical charges that may have been incurred for “outsourced” services (third-party service providers) in relation to the proposed covered transactions and the circumstances under such services are procured, i.e., on a temporary, or overflow basis or on a more extended basis;

  o The manner in which the taxpayer has computed total operating costs for the proposed covered transactions, either historically or as proposed in a unilateral APA application;

  o A discussion of representative projects or tasks performed by the Indian affiliate;

  o A discussion of metrics or other information available to the taxpayer that it may have used to measure the complexity of services provided by the Indian affiliate, such as wage levels and educational or experience levels relative to industry or trade-group benchmarks for its region of operation, etc.

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Mexico Regulations Allow Deduction of Prorated Expenses Under Shared Expense Arrangements

Mexico’s Tax Administration Service (SAT) published regulations on 16 October 2014 that allow Mexican taxpayers to deduct shared expenses incurred on a pro rata basis with nonresidents, provided certain requirements are met, despite a specific prohibition on the deduction of such expenses in the Income Tax Law (ITL). This article summarizes the requirements under the regulations.

The October regulations were a consequence of the decision issued by the second Chamber of the Supreme Court of Justice on 19 March 2014, in which the court held that the prohibition
under the ITL could not be justified, because Mexico’s transfer pricing rules require taxpayers
to adjust their transactions with nonresident related parties to arm’s length terms. The
Supreme Court decision does not include a specific date for the termination of the prohibition
on the deduction of prorated expenses. This leaves open the possibility that prorated expenses
incurred in previous years may be deductible for tax purposes if the requirements of the new
regulations are met.

Requirements for Deducting Shared Expenses

In addition to the general deductibility requirements contained in the ITL and other regulations,
specific requirements must be met under the new regulations for shared expenses to be
deductible. For example, such costs must be strictly necessary for the company to carry out its
activities, and there must be a reasonable connection between the expenses incurred and the
benefit received, or expected to be received, by the company. Additionally, the taxpayer must
demonstrate that the transaction was agreed upon at arm’s length terms and must maintain
transfer pricing documentation.

Reasonable connection between expenses incurred and benefit received: It is necessary
to demonstrate that there is a reasonable relationship between the expenses incurred and the
benefit received, or expected to be received, by the taxpayer that incurred those expenses.
The regulations emphasize the importance of the transfer pricing analysis for prorated expense
transactions, and lay down the following specific requirements:

- Each party to the expense sharing arrangement must have access to the details of the
transaction, how the anticipated profits will be determined, the prorated expenses
incurred, and the profits received.
- The participants must be companies that will mutually benefit from the agreement.
- The agreement must specify the nature and extent of the benefits that will be available
at a global and an individual company level with respect to the expenses incurred and
prorated among the members of the group.
- The agreement must provide for prorated expenses, using a method of allocation that
reflects the costs in relation to the expected benefits.
- The agreement must specify the scope of the transactions covered and the term of the
agreement.
- The following transfer pricing documentation must be retained for each transaction that
takes place; otherwise, the shared expenses will not be deductible:
  - Name, country of incorporation, tax residence, country where the company has
    its main business administration or place of effective management, tax domicile,
    and the tax identification number of each related party involved in the prorating of
global expenses or that will benefit from the prorating;
  - Description of the transactions and the terms of the agreement;
  - Functions or activities performed by each related party involved in the transaction
    and, when appropriate, the assets used and risks assumed by each party;
  - Documentation supporting the global expenses incurred, including
documentation indicating that the taxpayer confirms that an entity resident
abroad effectively incurred such expenses;
  - Details on how the prorated expenses were paid and evidence of such payment
(bank statement, record of wire transfer, journal entry, etc.);
o Documentation demonstrating that the transaction was carried out on arm’s length terms, the transfer pricing method used, and how the method was developed;
o Documentation showing how comparable operations or companies were determined for each transaction; and
o Supporting documentation regarding future transactions and the projections used as a basis for calculating prorated expenses and expected benefits, as well as the prorated expenses effectively incurred and benefits actually received.

Actual provision of services to related parties: If an expenditure for services is incurred between related parties, the taxpayer is required to demonstrate that the services actually have been provided to be eligible to deduct the expenditure. Unless the taxpayer produces evidence to the contrary, services will be deemed not to have been provided if:

- Under the same conditions, an unrelated party would not have been willing to pay for such services or perform the services;
- A related party performed the services only because of its interest in one or more of the related parties;
- Services or transactions carried out by a related party involve duplication of a service performed by another related party or a third party; or
- An expenditure for services is duplicative or included in other costs, expenses or investments made by the taxpayer (e.g. interest, royalties, technical assistance fees, commissions or advertising expenses).

Comments

The regulations have been well received by multinational groups, because historically it was not possible to deduct an allocation of shared expenses that benefited subsidiaries or affiliated companies in Mexico. Under the regulations, these groups may properly deduct expenditures that benefit their companies in Mexico, provided they meet the relevant transfer pricing and tax requirements.

However, the complexities resulting from the number and nature of the requirements for the deduction may prevent taxpayers from benefiting from the deduction. In addition, some concepts included in the rules, such as a “reasonable relation between the expenses incurred and the benefit received” imply a subjective assessment, but the regulations do not provide procedures or guidelines that allow taxpayers to clearly establish they have fulfilled this requirement. Therefore, taxpayers should consider evaluating on a case-by-case basis the costs and benefits of claiming a deduction for expenses incurred pro rata with nonresidents.

The 2014 Supreme Court decision may allow taxpayers to pursue deduction claims for years before 2014 through the courts, so the availability of such deductions in prior years should not be dismissed. The regulations may provide taxpayers with some indication of the factors the tax authorities likely would consider in evaluating the deductibility of this type of expense.
Taiwan Releases Amendments to Transfer Pricing Guidelines

Taiwan’s Ministry of Finance on March 4 released amendments to its transfer pricing guidelines that include a new definition of “business restructuring,” a lowering of the threshold amount to obtain an advance pricing agreement (APA), and the introduction of an APA prefiling conference option and the possibility of entering into bilateral and multilateral APAs.

The major changes to the regulations – formally known as the Rules Governing the Assessment of Income Tax for Profit-Seeking Enterprises on Non-Arm’s-Length Transfer Pricing – are discussed below.

Definition of Business Restructuring

The definition of a business restructuring has been refined to mean a reorganization or reallocation of activities carried out by a multinational enterprise or group regarding the functions, assets, and risks of related parties or the termination, renegotiation, or transfer of business terms or arrangements between such parties. Business restructurings include the following:

- A change of functions from a full-fledged distributor to a limited-risk distributor;
- A change of functions from a full-fledged manufacturer to a contract or toll manufacturer;
- A transfer (such as centralizing or segregating) of intellectual property (IP) rights;
- A streamlining, winding up, or liquidation of a business; and
- Other arrangements announced by the MOF.

Any profit distribution resulting from a business restructuring must be on arm’s length terms, as must any compensation for the reallocation of functions and risks, both before and after the restructuring. In determining whether the arm’s length principle is met, the following must be taken into account:

- Consideration for the reallocation of risks
  - Whether the reallocation of risks during the business restructuring conforms to the economic substance;
  - Whether the allocation of functions/assets/risks/profits in the controlled transaction both before and after the business restructuring is on arm’s length terms; and
  - Whether the risk bearers have the control and financial capacity to assume such risks.
- Arm’s length compensation for a business restructuring
  - The business reasons and the expected benefits of a business restructuring;
The rights and obligations of the participants before and after the business restructuring;
- Whether the allocation of potential profits is matched with its respective risk allocation;
- Whether the compensation for the transfer of tangible/intangible assets is appropriate; and
- Whether compensation paid for losses suffered by one of the parties involved in the restructuring as a result of a termination or renegotiation of a contract is sufficient and appropriate.

The enterprise must carry out a comparability analysis of the controlled transactions after the business restructuring to determine the appropriate transfer pricing method, and it must compare the compensation to the operating profit both before and after the restructuring.

The Taiwan tax authorities will review all documents related to a business restructuring to determine whether the controlled transactions are “genuine,” and if the economic substance of the controlled transactions differs from their form, the authorities will make the appropriate adjustments to ensure the transaction is on arm’s length terms.

According to Taiwan’s transfer pricing guidelines, the transfer pricing report should include a two-year analysis of the functions and risks, because these tend to change following a business restructuring.

**Advance Pricing Agreements**

Under the previous rules, taxpayers could apply for an APA when the aggregate amount of the controlled transactions was at least NTD 1 billion, or the annual total amount of the controlled transactions was at least NTD 500 million. The amendments reduced the threshold amount of the total controlled transactions to NTD 500 million and the threshold amount of controlled transactions per year to NTD 200 million. The period in which full documentation and the transfer pricing report must be submitted has been extended from one month to three months after receipt of the acceptance letter from the tax authorities.

Additionally, a prefiling conference option was introduced under which the Taiwanese tax authorities would be required to notify the applicant whether it accepted or rejected the APA application within one month after the prefiling conference. The amendments also introduce the option of applying for a bilateral or multilateral APA under a relevant income tax treaty or regulations.

**Other Changes**

The amendments to the transfer pricing guidelines also include the following:

- The net cost plus (NCP) method, a common profit level indicator, was added to the transfer pricing guidelines, following a ruling issued by the Ministry of Finance (Ruling No. 09704541020).
- The profit split method may be used when “all participants in a controlled transaction make unique and valuable contributions.”
• Transfer pricing documentation may be provided at the time the final tax return is submitted, following a 2009 ruling issued by the MOF (Ruling No. 09800470990).

Conclusion

The most significant changes to the transfer pricing guidelines are the new definition of business restructuring and the reduced threshold amount required for an APA.

Multinational enterprises should take the following into account when carrying out business restructurings:

• These types of transactions will be subject to scrutiny by the tax authorities and likely will be audited, with a focus on economic substance rather than form. The taxpayer should have sufficient supporting documentation available for the tax authorities to review.
• When an enterprise is carrying out structural or IPO planning, the compensation before and after the business restructuring should be on arm’s length terms.
• Review the transfer of valuable intangible assets and its relevant income before and after the restructuring.

By lowering the threshold amount and adding the prefiling conference option to the APA procedure, the MOF is encouraging enterprises to apply for APAs. If the enterprise has controlled transactions that involve large amounts or complicated controlled transactions, applying for an APA could help mitigate transfer pricing audit risks. Given that Taiwan currently is discussing the possibility of signing tax treaties with a number of countries, including China and Japan, applying for a bilateral APA in the future could further reduce the risk of double taxation for enterprises.

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Deloitte Delivers Comments on Identification and Importance of Risks at OECD Public Consultation

The Organization for Economic Cooperation and Development (OECD) on March 19-20 convened transfer pricing practitioners, tax authority representatives, and other interested parties at a public consultation on transfer pricing issues. The event focused on matters addressed in four discussion drafts that deal with work in relation to Actions 8, 9, and 10 of the Action Plan on Base Erosion and Profit Shifting (BEPS):

• Revisions to Chapter I of the transfer pricing guidelines (including risk, recharacterization, and special measures);
• Low-value-adding intragroup services;
• Profit splits in the context of global value chains; and
• Transfer pricing aspects of cross-border commodity transactions.

Deloitte Tax LLP was invited to participate in the consultation, and Philippe Penelle, a principal with the Los Angeles office, represented the transfer pricing group. Penelle’s comments on the identification and importance of risk, which refer to the discussion draft on the revisions to Chapter I of the transfer pricing guidelines, are reproduced below.

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Thank you for giving Deloitte Tax LLP the opportunity to participate in these public consultations. Our firm has prepared the following remarks.

Paragraph 22 at page 9 of the Discussion Draft reads:

“Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized.”

We wholeheartedly agree. The relationship between risk and expected return is at the heart of the application of the arm’s length principle. The application of the arm’s length principle starts with an assessment of the risks involved by reference to the written contract, and through a functional analysis. It is then followed by a mapping of the asserted level of risk into an open market measure of expected returns.

For every level of market-correlated risk, the open market provides one and only one expected return, regardless of any other attributes of the underlying asset. This Law of One Price is what ensures the absence of arbitrage in competitive markets, and therefore provides the arm’s length principle its objective efficacy at pricing transactions that took place outside of the competitive forces of the market under the subjective pricing choices of the MNE. The arm’s length principle is all about pricing risks.

Because not all risks are created equal, and not all risks are priced in the open market, we welcome the provision of additional guidance to help taxpayers and tax authorities price risks consistently with how the open market prices risks; that is the mandate of the arm’s length principle.

Businesses, investments, projects, transactions, whether involving financial assets or real assets all have one critical thing in common – they involve obligations of cash outflows and promises of cash inflows. These expected cash inflows and outflows are uncertain; they are subject to volatility.

Some of that volatility can be managed, some cannot. Some of that volatility is priced by the open market, some is not. Investors do not move along the efficient risk-expected return frontier by trading risk directly, they do so by trading the underlying promises and obligations of cash flows embedded in assets, contracts and cost structures.
Only risks that are priced by the open market are relevant to a transfer pricing analysis; they are called “market-correlated risks” – we alluded to them earlier in our remarks. Non-market-correlated risks are diversifiable through proper risk management techniques. Market-correlated risks, on the other hand, are by definition not manageable. We note that the US Treasury Regulations draw this critical distinction between market-correlated risks and non-market-correlated risks; it is of the utmost importance in a correct application of the arm’s length principle.

Because the impact of market-correlated risks is non-manageable, we believe the importance of the risk-management function in the discussion draft is significantly overstated. Risk management does not provide a company a permanent competitive advantage. Risk management functions are routine functions that command a routine return in the examples at paragraphs 46, 47, and 63.

We believe that it would be helpful for the guidance provided in the discussion draft to move away from suggesting that individual risks can be priced in isolation of the bundle of cash flows they are attached to in the subject transaction, because individual risks are not directly traded in the open market, nor are they directly observable. We recommend that the guidance should focus on a specific analysis of the interaction of all market-correlated risks in reference to the assets, contracts, and cost structures involved in the subject transaction. That guidance would then be consistent with the valuation guidance provided in Chapters VI and IX.

We believe that a number of the risks listed at paragraph 42 are diversifiable by appropriate routine management techniques, and are therefore less relevant to a correct application of the arm’s length principle. The focus of the guidance should be on the identification of market-correlated risks and the pricing thereof by the open market.

One of the most important determinants of risks relevant to transfer pricing is the cost structure of a company. We urge the OECD to provide guidance to that effect, and to incorporate that factor in the analyses provided in the examples at paragraph 57, 60, and 91. All of these examples include situations where fixed costs are shifted from one party to another. Fixed costs magnify market-correlated risks. A rational investor would not accept the funding of incremental fixed costs without an appropriate increase in expected return. Fixed costs are a fundamental economic attribute of the transactions described in these three examples, but are not addressed in the analysis provided in the draft. Recognizing them would fundamentally alter the conclusions reached in the draft for each of the examples.

This concludes our remarks. Thank you for your attention.

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Russia Enacts New Rules on Interest Deductibility and Application of Transfer Pricing Rules to Loan Transactions

The president of the Russian Federation on March 8 signed Federal law № 32-FZ introducing amendments to the Tax Code related to interest deductibility. The law was introduced to mitigate the negative tax implications of the ruble devaluation, and will apply to transactions from 1 January 2015. The major changes are summarized below.

The provision stipulating the application of the set limits of interest rates (so called “safe harbors”) solely to debt obligations on controlled transactions with the participation of banks has been eliminated. According to the amendments, the set interest rates limits should be applied to all controlled transactions for the purpose of determining the income and expenses of all parties involved. Income and expenses are to be recognized based on the actual rate if it exceeds the set minimum (for income) and if the actual rate is less than the set maximum (for expenses). Otherwise, income (expense) is recognized as interest calculated based on the actual rate, taking into account the transfer pricing rules set out in Chapter V.I of the Russian Tax Code (that is, the arm's length standard).

Special limit intervals have been introduced for debt obligations in rubles stemming from controlled transactions between Russian tax residents (Item 2, Article 105.14 of the Tax Code): from 0 percent to 180 percent of the Central Bank’s key rate (for the period January 1, 2015 – December 31, 2015) and from 75 percent to 125 percent of the Central Bank’s key rate starting 1 January 2016 (17 percent during January 1 – February 1, 2015, 15 percent as of February 2, 2015). Thus, based on the current key rate, the set limit interval is from 0 percent to 27 percent.

For other debt obligations in rubles (for example, between related Russian and foreign companies) the intervals are set from 75 percent of the Central Bank’s refinancing rate (8.25 percent) to 180 percent of the Central Bank’s key rate (January 1, 2015 – December 31, 2015), and from 75 percent to 125 percent of the Central Bank’s key rate (as of January 1, 2016). Thus, based on the current key rate, the interval on such obligations is from 6.19 percent to 27 percent.

For debt obligations set in currencies other than rubles, safe harbour limits refer to LIBOR/EURIBOR/SHIBOR rates increased by various ranges depending on the currency.

If the interest rate in the debt obligation is fixed, the Central Bank’s key rate (LIBOR/EURIBOR/SHIBOR rates) valid for the borrowing date should be applied. If a floating rate is utilized, the Central Bank’s key rate (LIBOR, EURIBOR, SHIBOR rates) valid for the date of recognition of interest as income (expense) is to be applied.

Changes to Thin Capitalization Rules (Article 269)

Until the end of 2015, for purposes of determining the maximum amount of interest on controlled debt in foreign currencies provided before October 1, 2014, and deductible for corporate income tax purposes during the period from July 1, 2014, to December 31, 2015, the amount of controlled debt is determined based on the lower of the two Central Bank exchange
rates: the exchange rate at the end of the reporting period or the exchange rate valid for July 1, 2014 (1 USD = 33.84 RUB; 1 EUR = 46.18 RUB).

The value of the borrower’s owned capital should be determined regardless of positive or negative foreign exchange differences caused by fluctuations of the Central Bank’s exchange rate from July 1, 2014 till the end of the reporting period.

The maximum amount of interest expenses deductible for corporate income tax purposes for the period December 1 – December 31, 2014, provided there are no debt obligations to Russian entities issued in the same quarter on comparable terms or at the taxpayer’s choice of deductible interest expenses for ruble loans, is deemed to be equal to the interest rate set out in the respective agreement but not exceeding the Central Bank’s refinancing rate multiplied by 3.5.

It is worth noting that the new law does not introduce the expected changes to thin capitalization rules adding loans from foreign sister companies to the list of controlled debts. However, there is another adjustment to the Art. 269 currently in process, which is expected to cover this issue.

Other Changes

Starting 1 January 2015, significant changes were introduced to the tax accounting of interest on loans. Historically, various restrictions on the level of deductibility of interest existed in Russia. New rules assume that no further restrictions should exist if the loan transaction is not considered a controlled one.

With respect to controlled transactions, the following rules should apply:

- Either interest income/expense on the controlled transactions should be defined in accordance with the transfer pricing rules, which effectively means that if the interest level is at arm’s length no restrictions on deductibility5 should apply;
- Taxpayers have the right to use “safe harbor” provisions for deductibility purposes – various levels for the Russian ruble, the euro, and the US dollar and other currencies were introduced.

Update on Changes to Transfer Pricing Documentation

Effective January 1, 2014, thresholds are no longer applicable to the transfer pricing notifications and documentation requirements for transactions between Russian taxpayers and their related parties. In other words, all cross-border intragroup transactions are subject to the notification and documentation requirements.

A threshold of RUR 1 billion will apply to transactions conducted between two related Russian companies (other limits exist for special cases, for example, if one of the parties applies a beneficial tax regime). As a reminder – before January 1, 2014, transitional transfer pricing rules were in place, whereby transfer pricing notifications and documentation had to be

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5 However, thin capitalization rules may apply.
prepared only if the total volume of cross-border controlled transactions exceeded RUR 80 million.

Transitional rules were also applicable to penalties for violations of transfer pricing legislation. Starting from FY 2014, a 20 percent penalty will apply in addition to late payment interest (the penalty will increase to 40 percent starting from FY 2017).

The deadline for preparation of the transfer pricing notification for FY 2014 is 20 May 2015, while transfer pricing documentation for FY 2014 should be available for review by the tax authorities after 1 June of 2015.

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Review of Georgia’s Transfer Pricing Regulations

The Tax Code of Georgia (TCG) contains specific provisions aimed at regulating taxation of transactions between related persons located in different tax jurisdictions, or entities incorporated in offshore/low-tax jurisdictions and carrying out transactions with Georgian entities.

The “Instruction on Valuation of International Controlled Transactions” issued by the Ministry of Finance of Georgia entered into force in 2014. The instruction regulates transfer pricing issues in Georgia and determines:

- Valuation methods for international controlled transactions;
- Comparability of unrelated transactions and rules for reviewing transactions;
- Information and list of documents to be provided to the tax authorities;
- Sources of information on market prices;
- Criteria based on which the price of the assessed transactions shall be deemed as the market price;
- Procedures for the advance pricing agreements of international transactions;
- Rules of using the range of prices, terms and other procedural issues.

The instruction is based on the Transfer Pricing Guidelines for Multinational Companies and Tax Administrations created by the Organization for Economic Cooperation and Development (OECD). According to the instruction, if something is not regulated by the TCG or the Instruction itself, the OECD guidelines should apply.
Under the TCG, a taxpayer is entitled to obtain from the tax authorities a legally binding advance ruling on prices for cross-border transactions if the amount of the transaction exceeds GEL 50,000 000 and the prices will be applicable for profit tax purposes. The ruling should be obtained before the commencement of the transaction and is valid for a definite period of time.

According to the TCG, two persons are related if one of them is directly or indirectly involved in the management or holds shares in the capital of the other person, or if the same persons are directly/indirectly involved in the management or hold a share in the capital of a third person. A person is regarded as being involved directly or indirectly in management, control, or capital if it holds directly or indirectly more than 50 percent of an enterprise, or if it practically directly or indirectly takes control over business decisions.

Pursuant to the instruction, “direct or indirect practical control over business decision” includes the following:

- A person can directly or indirectly own or control a majority of shares with the voting rights in a company;
- A person can directly or indirectly control the composition of the board of directors;
- A person can directly or indirectly earn 50 percent or more of the shares in profits of the enterprise;
- The total amount of loans directly or indirectly granted by a person to an enterprise and loans of that enterprise directly or indirectly guaranteed by the person is greater than 50 percent of the value of the enterprises’ total assets;
- More than 50 percent of an enterprise is directly or indirectly owned or controlled by a relative of a person;
- Except for those listed above, business decisions of an enterprise can be proved based on facts and circumstances.

The Georgian tax legislation envisages the following five specified pricing methods for evaluating whether the prices are at arm’s length:

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

The instruction envisages that the comparable uncontrolled price method will have priority, and that the first three methods listed are preferred over the last two methods.

Upon request from the Georgian tax authorities, taxpayers must provide transfer pricing documentation prepared according to the requirements set forth in the instruction within 30 calendar days of the request.

The transfer pricing documentation should include:
1. An overview of the economic operations/transactions of the Georgian enterprise, including the analysis of economic factors that influence and impact the price of its goods and services;
2. A description of the corporate organizational structure of the Georgian enterprise that encompasses all elements necessary for analyzing the controlled transactions;
3. A description of the controlled transactions;
4. A description of the transfer pricing method selected, and the reason why the particular method was selected;
5. A comparability analysis;
6. All economic analysis and forecasts that were applied as the basis in the course of elaboration of the transfer pricing method;
7. Details of any advance pricing agreements or prior decisions that are relevant to the transactions in question;
8. Conclusion regarding compliance with the arm’s length principle and if necessary, any amendments to transaction price/taxable income made to achieve compliance with the arm’s length principle;
9. Any other information that could affect the assessment of the transactions in question.

According to the instruction, if a Georgian entity’s annual tax turnover is below GEL 8,000,000 it would be deemed to meet the requirements related to the requested documents, provided an update of the external comparable transactions is carried out every third year, if there have been no material changes in the activities of the Georgian enterprise, the comparable transactions, or the economic circumstances.

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