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Global Transfer Pricing

Arm’s Length Standard

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In this issue:

BEPS Action Plan Item 13: The New Documentation Standard and Implications for the Financial Services Industry

The Organization for Economic Cooperation and Development completed and released the *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* in an unprecedented time frame, reflecting G20 consensus and political momentum surrounding the Base Erosion and Profit Shifting (BEPS) Project, and BEPS Action Plan item 13, which calls for a reexamination of transfer pricing documentation, in particular.

The immediate implication of the new guidance is that it will transform Chapter 5 of the OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* from broad recommendations to specific, prescriptive standards for documentation and reporting. The OECD has not recommended a specific effective date for the changes to Chapter 5. The effective date of the changes will depend on the domestic law of the adopting states.

This article outlines the specifics of the new guidance, the uncertainties, the general implications for multinational enterprises (MNEs), and specific implications for financial services MNEs.

Specific guidance

The OECD has adopted a three-tiered documentation approach that includes: (1) a country-by-country (CbC) report to provide a global financial snapshot of an MNE; (2) a master file to provide a high-level view of a company's business operations and important information on a company's global transfer pricing policies on intragroup services, intangibles, and financing; and (3) a local file to provide an entity- and transaction-level transfer pricing analysis to demonstrate the appropriateness of specific arrangements and pricing.

CbC reporting is a new concept for the international tax world, and it represents the biggest change in the revised Chapter 5. The CbC template includes eight items:

- Revenues (broken out into unrelated-party and related-party revenues);
- Profit(loss) before tax;
- Cash income tax paid;
- Accrued income tax;
- Capital;
- Accumulated earnings;
- Number of employees; and
- Tangible assets.

The template requires disclosure of only the total amount of each item for each country for entities consolidated in the MNE's financial statements. The template requires that each separate company in each country in the group be listed, along with its activity code and effective place of management.

In preparing the CbC template, each MNE may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, regulatory financial statements, or internal management accounts. Each MNE is required to provide a short description of the sources of data that it used in CbC reporting. The MNE should use the same data source year after year (any changes in the source data must be explained). If statutory financial statements are used as the basis for reporting, all amounts should be translated to the stated functional currency of the reporting company at the average exchange rate for the year. No accounting adjustments or reconciliations are required.

The master file is intended to provide a high-level blueprint of the MNE's transfer pricing practices in its economic, legal, financial, and tax context. The information required in the master file goes significantly beyond what is currently included in transfer pricing documentation for any given country. It must include descriptions of profit drivers and functions that contribute to value creation, as well as descriptions (graphic or written) of the supply chain for the five largest products and services, plus other products or services exceeding 5 percent of an MNE's turnover. It requires the provision of a list of important intangibles and which entities own them. It also requires disclosure of transfer pricing policies for intragroup services, intangibles-related transactions, sources of unrelated-party funding, intragroup financing entities, and intragroup financing policies. Finally, it requires the disclosure of an MNE's consolidated financial statements, unilateral income allocation rulings, and unilateral advance pricing agreements (APAs).

The master file can be prepared either on an overall company basis or a products group basis. However, the OECD provides that if the master file is prepared on a product group basis, all product groups must be submitted to all tax authorities, even if the local subsidiary is part of only one product group.

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The local file will contain much of the same information traditionally included in transfer pricing documentation reports. Although the local file will be centered on a traditional functional and economic analysis, the new guidelines are more prescriptive than the documentation rules in many countries, and require additional details not required or contained in many documentation reports. For example, the new guidance calls for the disclosure of local management reporting lines and the locations of those reporting managers, as well as copies of any APAs and other tax rulings the local jurisdiction is not party to and that are related to the controlled transactions covered in the local file in question.

The new guidelines state that for local file economic analysis searches for comparable companies need be completed only every three years if the functional profile of the company has not changed, although the data on the comparable companies must be updated annually. The new guidelines support the use of local comparables when local comparables are reasonably available.

Uncertainty

The major uncertainties surrounding the new guidance relate to implementation, harmonization, and materiality.

There are at least two dimensions to the implementation issues regarding the new guidance. One dimension involves the coordination and dissemination of CbC reports and master files. Many taxpayers have expressed a preference that these two tiers of documentation be provided to headquarters location tax administrations, which in turn would be responsible for ensuring the confidentiality and proper dissemination of the documents to other countries' tax administrations. The OECD has noted that it will provide guidance on this option for coordination and dissemination, and possibly others options, in January 2015.

The second dimension involves the implementation of the guidance at the country level. This involves consideration of the priority countries place on changing their local transfer pricing regimes and the means to make such changes, such as through bilateral tax treaties, regulatory or administrative rule changes that can be handled outside of legislative or parliamentary procedures, and legal changes requiring legislative or parliamentary action. Many commentators suggest that 2016 would be the earliest possible year for country implementation; however, there have already been anecdotal reports of tax examiners requesting the type of information contained in the CbC report and master file as a part of local tax examinations.

Many MNEs are uncertain whether they will need to prepare the three-tier documentation to meet the foreign jurisdiction requirements before their own home country imposes new requirements. To the degree a foreign jurisdiction's requirements are based on its domestic regulations or law, the answer may be yes. So, for example, if a foreign jurisdiction requires entities to comply with the CbC reporting requirement under its domestic laws but the entities' home country does not, taxpayers will somehow need to meet the foreign jurisdiction's requirement.

One key objective the OECD emphasized in undertaking Action item 13 was the desire to provide MNEs with a more consistent, harmonized documentation framework across countries.

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However, the revised Chapter 5 sends mixed signal about harmonization, as early as the introduction. It notes that eight countries – Argentina, Brazil, China, Colombia, India, Mexico, South Africa, and Turkey – expect that they will need information the OECD requires in the templates. Specifically, these countries appear to want additional transactional data regarding related-party interest payments, royalty payments, and especially related-party service fees. Thus, the hope that OECD transfer pricing documentation guidance would create a “one size fits all” template must be tempered with the reality that one size may fit many, but that differences in country-specific requirements won’t disappear. Thus, on a prospective basis, some uncertainty remains as to what data MNEs will ultimately need to gather, validate, collate, and explain in, or as a supplement to, the CbC reports.

Another consideration the OECD emphasized with Action item 13 was the balancing of taxpayer burden against tax administrations’ need for information. As prescriptive as the new guidelines are regarding content requirements, they lack concrete advice geared toward reducing the myriad materiality thresholds MNEs face.

General Implications

MNEs should expect that the greater transparency associated with CbC reporting and the master file may create new risk management challenges, that the availability of CbC reporting data may influence tax administrators’ preference for two-sided analysis of transfer pricing economic results, and that the data requirements of CbC reporting may result in more emphasis on manual or technology-driven data processing capabilities.

The worrisome aspect of increased transparency is tax administrators’ visibility into data that may have only a limited bearing on a specific transaction, but may still provide tax administrators with new arguments leading to formal adjustments or taxpayer-initiated amended returns. Arguments focused on consistency of arrangements and pricing may be more prevalent even when seemingly valid economic arguments exist for differences in arm’s length transfer prices across locations.

From a risk management perspective, MNEs may need to replicate the thinking of tax administrators reviewing CBC reports, and may need to find ways to manage the risk posed by CbC reporting results and master file presentation of policies, compared to local file analysis of actual transfer prices. One critical success factor for this is likely to be the governance and control of transfer pricing, so that tradeoffs between policies and outcomes and policies and exceptions are addressed at the appropriate level in MNEs.

There is also a concern that the CbC template might lead more frequently to the allocation of taxable income on the basis of headcount and/or tangible assets. In the past, an MNE may have felt reasonably confident that a rigorous demonstration of the arm’s length nature of related-party pricing could be based on an evaluation of the functions performed and risks assumed by the entity located in a country (in other words, a one-sided test of transfer prices) the latest OECD guidance suggests that tax authorities are increasingly likely to focus on multilateral analyses (such as revenue or profit splits) as a primary or corroborative test of transfer pricing policies.

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The concern that tax authorities may be more likely to assert the need for revenue or profit splits is likely to be exacerbated by the OECD's new guidance on comparability factors such as location-specific advantages and the broader definition of intangibles as articulated in the new Guidance on Transfer Pricing Aspects of Intangibles, issued under BEPS Action Item 8. By according location-specific characteristics the status of a comparability factor, the OECD has put tax authorities on firmer footing when using location-specific arguments as a basis for rejecting the taxpayer's transfer pricing method. When viewed in concert with a broader definition of intangibles; the OECD's view that economic ownership of intangibles can be split among multiple entities; and CbC reporting that will provide tax authorities significantly more information about the amount and location of taxable income, it is reasonable to expect that in the future, the adjustments proposed by tax authorities are more likely to be based on profit split methods.

For many MNEs, the process of locating, collecting, validating, and presenting the data necessary for the CbC report is likely to involve significant manual effort and to be very time consuming. Accordingly, many MNEs will have to evaluate their CbC report production capabilities and the cost and benefits of technology-driven solutions, much the same way they would when dealing with other data-heavy, time-constrained, operationally risky finance processes. This inflection point for transfer pricing management may offer opportunities to leap ahead in overall transfer pricing data management capabilities, which can have beneficial effects in areas other than CbC reporting, such as risk monitoring, escalation, and remediation.

Implications for Financial Services MNEs

Some of the foreseeable implications for financial services MNEs include the following.

Potentially significant challenges with revenue reporting for CbC – The OECD template requires that an MNE's revenues in a particular jurisdiction be split between related- and unrelated-party revenues. This may prove difficult for MNEs in the financial sector. In other industries, third-party revenues are likely to be attributed to the entity performing sales/distribution functions. This is not always true for financial services firms. In a global trading transaction, the entity that is credited with third-party revenues is frequently the entity into which the transaction is booked. The decision about which entity should book a transaction is frequently determined by client preference (for example, which entity has an International Swaps and Derivatives Association (ISDA) agreement? with the client) rather than by reference to what functions an entity performed or risks assumed in a transaction. Thus, the extent to which an entity has or does not have significant third-party revenue might not be a good indicator of value.

Misinterpretation of CbC summary statistics on number of employees – One possible misinterpretation of CbC results by tax administrators could be the correlation between profits and the number of employees. In some countries, companies with relatively low numbers of front office employees but high profits may find that to be a risk assessment factor that draws unwarranted attention. Whereas the correlation between value creation and number of employees in a manufacturing or other service industry context may be high, this is often not the case in a commercial and institutional financial services setting. To reduce the possibility of misinterpretation, it is important for financial services MNEs to avoid generic descriptions of

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their supply chains and value drivers, and to contextualize the company's value drivers fully in the local files.

Misinterpretation of CbC summary statistics on tangible assets – Tax administrations sometimes deem the presence of tangible assets other than cash an indicator of value creation. Financial services firms typically have relatively low levels of tangible assets on the balance sheet. In fact, when looking at the consolidated balance sheets of five large banks and five large insurance companies, tangible assets (not including cash) made up less than 2 percent of the balance sheet. Thus, tangible assets appear to be a poor indicator of value creation for the financial services industry.

Increased focus on treasury and intercompany finance – The master file is the point of convergence of factors to put pressure on financial services MNEs to articulate and support consistent intercompany finance arrangements and pricing. Other BEPS factors that affect this are the OECD's position on passive association in a credit support context (part of Action Item 8) and hybrid instruments (Action Item 2), as well as the OECD work on interest (Action Item 4) to take place in 2015. To address this, financial services MNEs transfer pricing and treasury functions will have to work in an even more coordinated manner to determine approaches to harmonizing policies globally and determining ex post transfer pricing test for real time pricing set by treasury departments.

Increased focus on intangibles – Depending on the sector and the level of the market, intangibles may play a relatively small role in the conduct of financial services business. By contrast, the potential for abnormal returns the OECD seems to attribute to intangibles in a general way, in the financial services industry may more accurately represent returns for the assumption of risk. But despite the fact that intangibles may not be significant value drivers for financial services firms, the master file and Action Item 8 covering intangibles converge to obligate financial services MNEs to identify intangibles and attribute ownership of the key intangibles to companies within the group. Many institutional financial services businesses involve technology cost sharing and/or intragroup services, including technology, and these should be examined carefully for policy and local file positioning. Indeed, this is what China's State Administration of Taxation is beginning to focus on during its discussions with and examinations of banks. Other types of intangibles such as licenses, brands, client relationships, and contracts should also be clearly identified, and clear positions on their contribution to value should be articulated. Failure to do so poses the risk that tax administrators may take the initiative in defining intangibles' value contribution.

Need to examine regulatory driven policy exceptions – In the financial services industry, situations can arise whereby regulatory constraints drive businesses to operate outside their normal value chain in a particular market. These situations can then drive exceptions to global transfer pricing policies. These types of exceptions are likely to be more problematic from a tax and regulatory perspective going forward. When these exceptions cannot be avoided, consideration should be given to the value of bilateral APAs (which must be reported only in the local files, rather than the master file) as means of mitigating the tax risk and providing a level of credibility in dealing with regulators.

Scope and design of master files – Compared to MNEs that trade in goods, the scope of what financial services MNEs will have to cover in the master file under the category of

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intragroup services will be very expansive in many cases. Additionally, determining annually which products must be presented in what detail is likely to create a good amount of variance from year to year in master file content for, say, a universal bank. Accordingly, the design of the master file should be carefully considered to address issues of granularity, completeness, flexibility over time, clarity, and conciseness. In many cases the historical global or regional files in place may provide content, but it should not be assumed that the structure of those files is best for OECD master file purposes.

Local file requirements – The prevalence in the financial sector of branch structures and product line reporting (as opposed to legal entity reporting) is likely to mean that MNEs in this sector may find the local file requirement to provide schedules that show how financial data used in transfer pricing reports reconciles to the annual financial statements particularly challenging.

Conclusion

The new chapter 5 of the OECD's transfer pricing guidelines will drive significant change in transfer pricing compliance, but more than that, it will change transfer pricing governance, risk management, and operations. While many of the drivers for this change are common across all industries, as has been noted by the OECD in prior transfer pricing and permanent establishment guidance, specific aspects of the financial services industry require particular attention. As financial services MNEs begin to prepare for a new era in global transfer pricing, they should carefully consider and address industry-specific transfer pricing management points and not just consider the new three-tier documentation a compliance exercise.

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Germany Adopts Final version of Regulation on Attribution of Profits to Permanent Establishments

The upper chamber of Germany's Parliament on October 10 adopted the final version of the regulation on the application of the arm's length principle to permanent establishments.

The branch profit attribution regulation includes a range of detailed rules on the application of the Authorized OECD Approach (AOA) in Germany, which was incorporated into German tax law last year.

The core idea of the AOA is to treat permanent establishments for tax purposes as if they were (nearly) fully independent and separate legal entities. This implies the consequent application

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of the arm's length principle to internal dealings between the permanent establishment and its head office, and between permanent establishments of the same company.

The branch profits attribution regulation has the stature of a law, and binds the taxpayer, the tax authorities, and the tax courts. It governs:

- The asset attribution and attribution of chances and risks to permanent establishments;
- The branch capital allocation;
- The recognition of "assumed contractual relationships" (dealings); and
- The application of the AOA to banks, insurance companies, and construction and exploration sites.

Germany generally follows the guidance provided by the OECD in the "Report on the Attribution of Profits to Permanent Establishments" of 22 July 2010. However, for some fact patterns the German branch profit attribution regulation provides more detailed rules than discussed by the OECD and reduces the range of alternative approaches available to the taxpayer. This is especially true for branch capital allocations, with regard to some refutable presumptions in the German regulation, which deviate from the OECD consensus, as well as with regard to the special provisions for construction, installation, and exploitation permanent establishments.

Changes to August 2013 draft

In comparison to the draft version of the regulation dated 5 August 2013, the German Federal Ministry of Finance (MoF) has responded positively to some requests for changes made by industry associations and tax experts. In particular, the following changes are welcome:

- The attribution of people functions to a permanent establishment is also possible in cases in which the permanent establishment relies on seconded personnel;
- A clarification that no contemporaneous documentation requirement is introduced for the profit attribution to permanent establishments;
- No assignment of people functions to a permanent establishment when those functions are performed in that location only for a short period of time (less than 30 days);
- The simplification of the attribution of macro hedging transactions; and
- Avoidance of the retroactive application of the new rules; the new rules are applicable for financial years commencing after 31 December 2014.

Unfortunately, with respect to the following issues, the MoF ignored heavy criticism formulated by business associations and in the tax literature on the following points:

- The fundamental differentiation between domestic and foreign permanent establishments, which from an EU perspective appears highly questionable. This is particularly relevant for the asymmetric approach prescribed for the branch capital allocation for industrial companies, banks, and insurance companies; and
- The allocation of insurance contracts to the general branch manager irrespective of his/her involvement in the underwriting process can be avoided only by a proper documentation of the facts and circumstances, which must be submitted to the supervisory authorities.

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The AOA's two-step approach

In accordance with the OECD PE Report, the attribution of profits to permanent establishments is performed in a two-step approach. In the first step, the people functions performed by the permanent establishment are identified based on the activities of locally employed personnel. Next, the assets used and risks assumed that are associated with those people functions are attributed to the different parts of the enterprise. Finally, the branch capital is attributed to the permanent establishment, taking into account the functions performed and risks assumed by the permanent establishment.

On the basis of this attribution, the internal dealings between the head office and its permanent establishment(s) and between permanent establishments of the same entity are identified, and an arm's length remuneration is determined. For this purpose, the provisions of the OECD transfer pricing guidelines apply by analogy.

Auxiliary Calculation

The branch profits attribution regulation also introduces the obligation for the taxpayer to prepare a separate balance sheet and profit and loss statement for the permanent establishment in accordance with the principles of the AOA (the "auxiliary calculation").

The auxiliary calculation comprises assets attributable to the permanent establishment, the branch capital, and other liabilities. Also, the fictitious revenues and expenses resulting from internal dealings must be recorded. Taxpayers must open the auxiliary calculation at the beginning of each fiscal year, must record all transactions during that year, and then close it at the end of the fiscal year.

The auxiliary calculation must be prepared at the latest when the permanent establishment's tax return for the pertinent fiscal year is filed. To avoid having this provision lead to a contemporaneous documentation requirement for the branch profit attribution, the new regulation states that the reasoning for the asset attribution and the identification of internal dealings must be documented in writing based only on the general transfer pricing documentation requirements. German law does not set a specific deadline for the preparation of transfer pricing documentation. However, the taxpayer must be able to provide transfer pricing documentation for its intercompany transactions within 60 days of a request by a tax auditor to avoid penalties for late submission. Notwithstanding this rule, it is advisable for taxpayers to appropriately document the reasons for the asset attribution when preparing their tax return, to ensure consistency between the submitted tax return and the transfer pricing documentation.

Asset attribution

The objective of the branch profit attribution regulation is to ensure the clear-cut of an entity's assets to its permanent establishments. Broadly speaking, the asset attribution must be based on the following people functions:

- Tangible assets: Usage;
- Intangible assets: Purchase/creation;

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- Investments/financial assets : Functional relation with business activities;
- Other assets: Purchase/creation;
- Business transactions: Facilitation of business transaction;
- Chances and risks follow the attribution of the assets or people functions they are associated with; and
- Hedging transactions follow the attribution of the assets they are intended to secure.

For all kinds of assets, escape clauses allow the attribution of assets to another people function, if the taxpayer can demonstrate that the other people function is more important for that asset.

A split attribution is generally not allowed, and may be applied only for intangible assets in exceptional cases when no direct attribution is feasible. However, a split attribution seems questionable against the background of domestic tax law and the principles of the AOA, which favor direct attribution to one permanent establishment and an arm’s length remuneration of any supporting function or resulting dealing.

Branch capital allocation and attribution of financing expenses

With regard to the branch capital allocation, the MoF’s final draft of the regulation retains the asymmetric approach for domestic and foreign permanent establishments proposed in the draft regulation, which was severely criticized by many observers.

According to the new rules, the capital allocation method is the preferred method to determine the branch capital of domestic permanent establishments of foreign companies. For this, the equity of the foreign company must be determined according to German tax law and attributed to the permanent establishments in relation to the assets, chances, and risks attributable to them. As a simplification rule, the taxpayer can work with the equity as shown in the foreign balance sheet, if this amount does not deviate significantly from the equity determined according to German tax regulations, or if appropriate adjustments can be performed in case of significant deviations.

Conversely, the regulation stipulates that for foreign permanent establishments of domestic companies the minimum capital approach must be applied primarily. This asymmetric approach stands in contradiction to the OECD PE Report, and clearly aims to maximize the German tax base. Thus, double taxation will most likely occur. If the taxpayer can demonstrate that another allocation method than the preferred method better reflects the arm’s length principle, it is allowed to apply the other method with additional restrictions.

Based on the branch capital allocation, other liabilities and the associated financing expenses are attributed – preferably directly – to the permanent establishment until its balance sheet is balanced. If the financing expenses cannot be directly attributed, or if this would be disproportionately burdensome, the average financing expenses on all not directly attributable liabilities must be used. If the directly allocable liabilities exceed the liability amount attributable to the permanent establishment, even the directly allocable liabilities and, therewith, the associated financial expenses must be reduced proportionally. This decreases the amount of tax-deductible expenses.

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Assumed contractual relationships

According to the AOA, internal dealings (“assumed contractual relationships” according to German tax law) between the head office and its permanent establishment(s) and between permanent establishments of the same company must be remunerated at arm’s length. The regulation says that any reattribution of assets to another permanent establishment constitutes such an assumed contractual relationship (transfer of assets). Furthermore, any economic activity for which unrelated parties would have concluded a contract qualify as a dealing (for instance, the internal provision of services).

However, in accordance with the OECD PE Report, an internal loan relationship is excluded, unless surplus liquidity that has accrued in the course of a financial year at a permanent establishment is evidently used by another permanent establishment of the enterprise until the end of the financial year.

In general, financing permanent establishments – permanent establishments that perform the enterprise’s liquidity management – are seen as service providers for the rest of the corporate group and should be remunerated using the cost plus method. The taxpayer can deviate from this presumption if it can demonstrate in an individual case that the financing permanent establishment performs activities of such significance that the financial assets should be attributed to the financing permanent establishment itself. Open balances on internal clearing accounts between the financing permanent establishment and the rest of the company do not bear any interest.

Special provisions for permanent establishments of banks, insurance companies, and construction companies

The branch profit attribution regulation has separate sections for permanent establishments of banks and insurance, construction, and installation companies, as well as exploitation permanent establishments of mining, oil and gas companies. These sections deal with the specifics of those industries.

Banks and insurance companies

The financial services sector is heavily regulated. Thus, the international profit attribution of banks and insurance companies must take into account regulatory requirements (such as those regarding capital endowment). Because the assumption of risks is the central business activity of banks (credit risks) and insurance companies (insurance risks), the OECD PE Report attributes the credit and insurance contracts to the permanent establishment that has performed the *key entrepreneurial risk-taking* (KERT) function.

The German branch profit attribution regulation follows the OECD reasoning and defines the key entrepreneurial risk-taking function of banks as that function responsible for the creation of the credit contract. In deviation from the OECD PE Report, the ongoing risk-management function does not qualify in general as a KERT function in the traditional banking business. Therefore, the credit contract can be attributed to the risk-management function only if the taxpayer can show in individual cases that such approach better reflects the arm’s length principle.

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In the case of insurance companies, and fully in line with the OECD PE Report, the underwriting function is defined as the key entrepreneurial risk-taking function. However, if the underwriting is not performed in Germany, a domestic permanent establishment of a foreign insurance company must document:

- That the domestic insurance branch indeed does not perform the most significant role in the underwriting process;
- That the general branch manager has not outsourced the underwriting by active decision-making and does not control it; and
- Where the KERT function is actually performed.

In addition, the foreign insurance company must submit this information to the supervisory authorities in Germany and in its home country. If the taxpayer does not prepare this documentation, the insurance contracts and all associated chances and risk are attributed to the German branch.

With respect to the recognition of internal dealings, internal reinsurance is categorically excluded from the definition of dealing.

The attribution of the credit and insurance contracts decides further about the attribution of the associated risks, which have to be backed with sufficient capital. An appropriate share of the “free capital” of a foreign bank and the surplus of a foreign insurance company must be attributed to a domestic permanent establishment based on the capital allocation method using risk-weighted exposure amounts (in the case of banks) and technical reserves (in the case of insurance companies) as allocation keys. In contrast to this, for foreign permanent establishments of domestic banks and insurance companies the minimum capital approach is the preferred method.

While the new regulations regarding the branch capital allocation represent uncharted waters for insurance companies, the actual rules for banks remain nearly unchanged. The fact that the simplification rule for small banks (i.e., 3 percent of total assets) has been extended to banks with balance sheets totaling up to €1 billion is appreciated.

Construction, installation, and exploitation permanent establishments

In the case of construction and installation companies, the branch profit attribution regulation stipulates a refutable presumption that the construction/installation permanent establishment renders a service to the rest of the company that must be remunerated using the cost plus method. If the construction/installation permanent establishment does not perform any significant people functions beyond the usage in connection with the deployed tangible assets (the machinery and construction material), these assets are attributed to the rest of the entity and are considered to be provided free of charge to the construction/installation permanent establishment. Thus, the expenses for these assets cannot be included in the cost base; in other words, the construction/installation permanent establishment is treated like a toll manufacturer.

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If the construction/installation permanent establishment performs activities that go beyond mere routine activities, the application of the profit split method is prescribed, whereby the split factor shall be the costs.

The regulations for exploitation permanent establishments follow along the same lines as the rules for profit attribution to construction/installation permanent establishments.

Effective date of new rules

The detailed rules of the branch profit attribution regulation apply for all fiscal years commencing after 31 December 2014. By contrast, the general principles of the AOA are already applicable for all fiscal years that started after 31 December 2012. The MoF is currently preparing “Administration Principles for the Audit of the Profit Attribution to Permanent Establishments” that will be published next year and will provide further guidance on the application of the AOA in Germany. It has been announced that these administrative principles will also cover questions arising from the different application dates of the specific rules set by the branch profit attribution regulation and the general principles of the AOA.

Profit Attribution Health Check

Taxpayers with permanent establishments in Germany should take action and check whether their international profit attribution is in line with the new detailed German rules. This is particularly true for:

- The attribution of assets, chances, and risks;
- The branch capital allocation and the attribution of financing expenses;
- The identification of assumed contractual relationships (dealings) and their arm’s length remuneration; and
- The preparation of the auxiliary calculation.

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France Publishes New Transfer Pricing Documentation Form

The French Tax Administration (FTA) on September 16 published the official form taxpayers must file to comply with the new transfer pricing documentation requirements imposed by Article 223 quinquies B of the French Tax Code. Companies subject to this new requirement must submit the new form, covering fiscal year 2013, by November 20, 2014.

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The official form is very similar to the draft document that had been circulated in May.

The form is a four-page table, with the following main requirements:

- A short description of the company (name, tax identification number, address) and the activities of its corporate group. In this section, companies now must list the name of their chartered accountant, as well as the name of their tax advisor;
- A list of the group's intangibles used by the French entity (stating the country of residence of the owner of those intangibles);
- A general description of the transfer pricing policies of the taxpayer's group;
- A list of all intragroup flows involving the French company, by nature of flows. For each flow, the information to be provided includes:
    - The nature of the transaction:
        - Revenues/expenses: sales/purchase of goods, services, commissions, patent royalties, trademark royalties, know-how royalties, other intellectual property revenues/expenses, financial revenues/expenses, etc.;
        - Purchase/sale of assets: patents, trademarks, going concerns, tangible assets, intangible assets, real estate properties.
    - The aggregated amounts per type of transaction if they exceed €100 000;
    - A list of the countries involved in the transactions; and
    - The transfer pricing method applied to the transactions (the comparable uncontrolled price method, the resale minus method, the cost plus method, the transactional net margin method, profit splits, or other methods).

Taxpayers also must disclose whether any major changes in their transfer pricing policy occurred during the year, and provide enough details on the potential changes.

The tax authorities also published a notice that provides detailed instructions for filling out the form.

The form must be completed in French, and sent to the FTA's department in charge of supervising the company. The FTA had mentioned previously that the form must be filed in an electronic format. However, the FTA has not provided specific instructions in this regard thus far; therefore, we believe that, for this first year, the form may be submitted in hard copy.

The automated review of this form will allow the FTA to perform analyses to identify potential discrepancies in a taxpayer's filings (errors, significant variations from past years, or differences with peers). This will give the FTA a large database on flows and transfer pricing methods applied by international groups, as well as a tool to better prioritize audits.

Taxpayers should proceed with caution in filling out the new form, and should consider the potential consequences of their statements. We strongly suggest that transfer pricing documentation be prepared in advance prior to the filing of the form. Indeed, having transfer pricing documentation will provide French taxpayers a full view of their transfer pricing situation, allowing them to fully anticipate and appreciate the consequences of the information provided in the Article 223 quinquies B form.

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Penalties for noncompliance with this new requirement are €150 for failure to file and €15 per instance of missing or erroneous information, with a €10,000 limit. We believe the penalties for failure to comply with this new obligation will be significantly increased in the next Finance Act for 2015.

Taxpayers should also be aware that this new transfer pricing documentation requirement does not replace the original requirement (under Section L13AA of the French Tax Procedure Code), which requires that full transfer pricing documentation be available at the time of a tax audit of a French company, and for which French law imposes specific penalties.

This article has been prepared by professionals in Taj, French tax and legal firm, member of Deloitte Touche Tohmatsu Limited.

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Czech Tax Authorities Seek Full Disclosure of Related-Party Transactions in Corporate Tax Return

In response to experience with transfer pricing tax audits, the Czech tax authorities have amended the tax laws to shift the burden of proof on transfer pricing cases from the tax authorities to taxpayers. The Czech Tax Administration also introduced a new form that must be attached to the Corporate Income Tax Return, providing information on the taxpayer's material related-party transactions.

The entities that will be subject to the new requirement are corporations that meet at least one of the criteria that trigger compulsory statutory audits, and also participated in cross-border related-party transactions, incurred losses, or received investment incentives in the form of tax relief.

More specifically, the new tax return attachment must be completed by taxpayers that meet at least one of the following criteria during the tax year:

- Total assets exceeding CZK 40 million;
- Net turnover exceeding CZK 80 million; or

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- Annual average number of employees higher than 50.

Those corporations also must meet one of the following conditions to be subject to the new filing requirement:

- Entered into transaction(s) with a related party residing in a foreign country;
- Incurred tax losses in the tax year, and simultaneously entered into related party transaction; or
- Obtained a promise of investment incentives in the form of a tax relief, and simultaneously entered into related-party transaction(s).

The entities subject to the new requirement must report details for each type of transaction, including the related party's country of residence, the nature of the transaction, the transactions' volume (both in terms of cost and income), as well as a summary of the related-party receivables and liabilities.

The information on the related-party transactions will be subject to a risk analysis performed by the tax authorities. While the tax authorities current approach is to select entities for audit at random, under the new regime there will be a focus on high-risk transactions and taxpayers, with an emphasis on demonstrating sufficient evidence to support a taxpayer's pricing.

The new attachment must be filed for the taxable period ending 31 December 2014.

The new attachment does not substitute transfer pricing documentation, which must still be prepared to prove how transfer prices were calculated and whether they were in accordance with the arm's length principle.

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Singapore Releases Proposed New Guidelines on Transfer Pricing Documentation

The Inland Revenue Authority of Singapore (IRAS) on 1 September published a consultation paper that sets out revised guidance on transfer pricing documentation. The proposed new guidelines are part of IRAS's ongoing efforts to require taxpayers to strengthen their due diligence in complying with the arm's length principle.

The consultation paper was released for public comment and feedback. Taxpayers were asked to submit their comments on the paper to IRAS by 24 September 2014. The IRAS consultation paper may be found at on their website
URL: http://www.iras.gov.sg/irasHome/page03a.aspx?id=8510

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Key Features

The proposed new guidelines set out to address the following broad aspects of transfer pricing documentation:

- The objectives of preparing transfer pricing documentation;
- Contemporaneous transfer pricing documentation – when to prepare it and what type of details are required; and
- Compliance consequences of inadequate transfer pricing documentation.

Some aspects of the new guidelines reaffirm – or do not deviate significantly – from the key concepts and guiding principles for preparing transfer pricing documentation under the existing Singapore transfer pricing guidelines. However, there are several notable new developments.

Transfer Pricing Documentation Requirement

The new guidelines are explicit in requiring taxpayers to "prepare and keep contemporaneous documentation."

In keeping with the existing guidelines, the proposed new guidelines do not impose a specific transfer pricing penalty for the lack or insufficiency of documentation. However, inadequate documentation may lead to the following "adverse consequences":

- The lack of documentation may increase the chances of transfer pricing adjustments under Section 34D of the Singapore Income Tax Act (SITA) during an audit;
- Consistent with the existing guidelines, IRAS may not support a taxpayer's mutual agreement procedure (MAP) application in the event of transfer pricing adjustments made by foreign tax authorities. However, the proposed new guidelines now highlight the possibility that IRAS may also decline APA applications filed by the taxpayer; and
- If the taxpayer fails to timely submit adequate documentation upon request by IRAS, it may be penalized under Section 94(2) of the SITA for not complying with the record-keeping requirements under SITA Sections 65, 65A, and 65B. The penalty under Section 94(2) involves a fine not exceeding S$1,000 or a jail term not exceeding six months in lieu of payment.

What constitutes contemporaneous transfer pricing documentation?

Under the existing Singapore transfer pricing guidelines, there is a call for transfer pricing documentation to be prepared in a timely manner, but there is no clear definition of what constitutes contemporaneous documentation.

In the proposed new guidelines, IRAS has indicated that it accepts contemporaneous transfer pricing documentation as records prepared prior to or at the time the transactions were entered into, and including up to the time of preparing the relevant tax returns. In other words, IRAS's requirement is that documentation should be prepared no later than the due date for filing the tax return for the year in question. This is believed to be in keeping with the "best practice" advocated by the OECD in its new guidance on transfer pricing documentation released on 16 September 2014.

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The proposed new guidelines ask that taxpayers prepare information concerning the group level as well as the entity level. In doing so, IRAS has in principle adopted the two-tier approach recommended by the OECD guidance, which comprises a master file that calls for new disclosure requirements regarding taxpayers' entire global operations and a local file. However, there are some key differences between the OECD's and IRAS's approach to transfer pricing documentation, as discussed below.

Group Level Documentation

Under Singapore's current transfer pricing guidelines, only general and brief information on the group, such as its line of business, industry, and principal business activities must be provided, and that information is typically incorporated as part of a single taxpayer transfer pricing documentation file.

The proposed new guidelines require substantially more group-level details, which should present "a good overview of the group's businesses." In Annex A to the proposed new guidelines, the following types of information to be included as group-level documentation are listed:

- A worldwide organizational structure chart, showing the location and ownership linkages among all related parties;
- A description of the group's business, including:
    - The group's lines of business, products and services, geographic markets, and key competitors;
    - Industry dynamics and market, regulatory, and economic conditions in which the group operates;
    - The group's business models and strategies, including any recent restructuring, acquisition, or divestiture;
    - Important drivers of business profits and a list of intangibles and the related parties that legally own them;
    - The principal business activities and functions of each group entity, including charts showing the supply chains of products and services; and
    - The business relationships (services provided, goods sold, development, ownership or exploitation of intangibles, financing arrangements, etc.) among all related parties;
- Details on the group's transfer pricing, including:
    - A functional analysis describing the contributions to value creation by each group entity – functions performed, risks assumed, and assets (including intangibles) used and/or contributed; and
    - The group's transfer pricing policies relating to all types of transactions between related parties within the group; and
- Consolidated financial statements of the group.

The expanded list of information required at the group level will require significantly more taxpayer time and effort to document. Further, such group level documentation would likely have to be prepared by the parent company of the multinational enterprise (MNE) group and shared with the Singapore entity. This raises the question whether IRAS would regard as inadequate documentation situations whereby the Singapore entity is not provided with group-

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level documentation by its parent company by the tax return filing date, but robust entity-level documentation has been prepared.

We expect commenters to provide substantial feedback on this point regarding the potential difficulties taxpayers may face in obtaining the information required.

One of the most controversial parts of the OECD guidance is the requirement for detailed country-by-country (CbC) reporting of certain information relating to the global allocation of profits, taxes paid, and certain indicators of the location of economic activity (tangible assets, number of employees, and total employee expense) among countries in which the MNE group operates. Consistent with its previous indications, the IRAS has opted not to include a requirement for a CbC template to be provided as part of the group-level documentation.

Entity-Level Documentation

The proposed new guidelines require entity-level documentation to "provide sufficient details of the subject taxpayer's business and the transactions with its related parties." Most of the proposed items required as entity-level documentation are already covered under the existing Singapore transfer pricing guidelines, but there are the following new items to note:

- An ownership structure chart showing the location and ownership linkages of the Singapore taxpayer with its holding companies (ultimate, intermediate, and immediate) and all subsidiaries and associated companies directly and indirectly held by the Singapore taxpayer (if such details are not provided in the group-level documentation);
- Description of the Singapore taxpayer's management structure, including a description of the individuals to whom Singapore management reports and the countries in which those individuals maintain their principal offices; and
- An organizational chart of the Singapore taxpayer, showing the number of employees in each department.

Some of this information might be challenging to provide, because the Singapore taxpayer may not have full access to the information.

Safe Harbor Threshold for Transfer Pricing Documentation Preparation

The proposed new guidelines introduce two situations wherein taxpayers are exempted from the obligation to prepare transfer pricing documentation:

- When the taxpayer is a small or medium-sized enterprise (SME) and the SME's related-party transactions are local transactions subject to the same Singapore tax rates.
- When the taxpayer applies the Singapore safe harbor mark-up of 5 percent for routine services.

SMEs, as defined by Spring Singapore, have annual sales turnover of not more than S$100 million or fewer than 200 employees.

The introduction of the safe harbor threshold for preparing transfer pricing documentation should serve to limit taxpayers' compliance and administrative costs. IRAS is seeking

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comments on other low-risk situations that should also be included under the safe harbor threshold.

The proposed new guidelines also recommend that taxpayers assess the adequacy and extent of their transfer pricing documentation by evaluating the level of transfer pricing risk and the adverse consequences of not having adequate documentation. The proposed new guidelines further caution that inadequate documentation may lead to upward transfer pricing adjustments and the rejection of MAP and APA applications by IRAS.

Maintenance and Update of Documentation

As mentioned above, the proposed new guidelines require contemporaneous transfer pricing documentation to be prepared no later than the tax return filing date for the fiscal year in question. However, taxpayers are not required to submit their transfer pricing documentation when the tax returns are filed. The documentation should be kept by taxpayers and submitted to IRAS when requested to do so.

The proposed new guidelines also recommend that transfer pricing documentation be reviewed periodically to ensure that the functional and economic analyses are still accurate and valid. The OECD guidance on documentation has recommended that searches in databases for comparables supporting the local file be updated every three years, whereas the financial data of the comparables should be updated every year. IRAS has not specified the frequency for documentation updates in the proposed new guidelines, and is requesting public feedback on this.

Conclusion

With the winds of change in the international tax environment, transfer pricing will continue to be a focal point for IRAS. The proposed new guidelines are a continuing indication of IRAS's interest in ensuring that taxpayers maintain sufficient transfer pricing documentation and comply with the arm's length principle.

Until the proposed guidelines are finalized, taxpayers should:

- Assess their related-party transactions to determine if they meet the safe harbor threshold for exemption from preparing transfer pricing documentation; if they do not, determine whether existing documentation is sufficiently contemporaneous in accordance with IRAS's requirements.
- For high-risk related-party transactions, conduct transfer pricing analyses and prepare supporting documentation before the relevant tax return is filed. Ideally, the transfer pricing analyses should be performed before the year-end so that any transfer pricing adjustments to adjust the prices/margins to reflect arm's length returns can be made before the books are closed. IRAS does not permit transfer pricing adjustments to be made through tax returns.
- Monitor further updates and guidance from IRAS, arising from this ongoing consultation on transfer pricing documentation, as well as the impending update to the existing transfer pricing guidelines and circulars expected before the end of this year.

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Marzen judgment: A significant addition to Canadian transfer pricing jurisprudence

Justice Georgette Anne Sheridan on June 10, 2014, released the Tax Court of Canada's decision in *Marzen Artistic Aluminum Ltd. v The Queen*.[1] The case dealt with appeals by window manufacturer Marzen Artistic Aluminum Ltd. (Marzen Canada) pertaining to transfer pricing adjustments made by the Minister of National Revenue regarding the disallowance of marketing fees paid to its wholly owned Barbados-based subsidiary in 2000 and 2001.

The *Marzen* case represents the most recent Canadian judgment dealing with transfer pricing issues, adding to decisions by the Supreme Court of Canada (SCC) and lower courts in *GlaxoSmithKline v The Queen*[2], the Federal Court of Appeal (FCA) and TCC in *General Electric Capital Canada Inc. v The Queen*[3], and the TCC in *Alberta Printed Circuits Ltd v The Queen*[4] and *McKesson Canada Corporation v The Queen*.[5]

Marzen reaffirmed certain tenets established in previous Canadian transfer pricing cases, such as the interpretive usefulness of the Organization for Economic Cooperation and Development (OECD) transfer pricing guidelines, a preference for the comparable uncontrolled price (CUP) method for performing transfer pricing analyses, and the importance of appropriately considering the functional profile and respective roles of related parties in a transfer pricing context. In addition, *Marzen* contributed to the "transaction-by-transaction" debate that arose in *Glaxo* by considering whether an "amalgam" transfer pricing approach, which combines entities and transactions, or an "entity-by-entity" approach is required for an appropriate transfer pricing analysis. Finally, *Marzen* is also the first Canadian case to directly consider the assessment of transfer pricing penalties by the minister.

Background

During the years under analysis, Marzen Canada was a Canadian corporation based in British Columbia, engaged in the design, manufacture, and sale of window products in British Columbia and the United States.

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[1] 2014 TCC 194, herein referred to as *Marzen*. Marzen Artistic Aluminum Ltd. has appealed the TCC decision.
[2] 2008 TCC 324, 2010 FCA 2011, and 2012 SCC 52, herein referred to as *Glaxo*. This case is ongoing, as the SCC referred the matter back to the Tax Court for a rehearing and redetermination.
[3] 2009 TCC 246, and 2010 FCA 344, herein referred to as *GE*.
[4] 2011 TCC 232, herein referred to as *APCL*.
[5] 2013 TCC 404, herein referred to as *McKesson*. McKesson Canada Corporation has appealed the TCC decision.

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Starline Windows Inc. (SWI), a non-arm's-length corporation in the Marzen Canada group of companies, was incorporated in the state of Washington, and was inactive until 1998. In 1998, SWI opened a sales office and storage facility in Washington, and its personnel solicited orders for Marzen Canada's window products from U.S. customers. During the 1998 fiscal period, SWI realized sales revenue of US$551,320 and incurred operating losses of US$487,309.

In 1998, Marzen Canada's owner, president, and sole director met with David Csumrik, a Barbados-based business consultant, for marketing advice to address SWI's struggle to achieve profitable sales levels in the U.S. market. Csumrik advised Marzen Canada to shift efforts from the Washington residential market to the burgeoning high-rise market in southern California. The advice appeared valuable, and was referred to as "game changing" considering the significant increase in sales in the U.S. market subsequent to Csumrik's advice.

After discussions with Marzen Canada, Csumrik established Starline International Inc. (SII) in 1999, with Marzen Canada as SII's only shareholder. SII's managing director was Csumrik, who was not related to Marzen Canada but provided advice to Marzen Canada's owner prior to SII's operations, as noted above.[6] SII was described as being in the business of marketing window products such as those manufactured by Marzen Canada.

The transactions under review by the TCC pertained to marketing fees paid by Marzen Canada to SII during 2000 and 2001. Under the Marketing and Sales Services Agreement (MSSA), Marzen Canada paid SII a monthly fee equal to the "greater of US$100,000 or 25% of gross sales initiated by SII of Window Products,"[7] as well as a "one-time bonus of 10% on confirmed contracts in the California market on condition that SII achieve at least US$10 million in net sales between August 1, 2000 and December 31, 2001."[8] Marzen Canada paid SII marketing fees of CA$4,168,551 in 2000 and CA$7,837,082 in 2001.

SII retained and engaged personnel of SWI to perform the day-to-day sales and marketing functions under a personnel secondment agreement (PSA), for which SII agreed to pay SWI a monthly fee to cover SWI's aggregate costs of employment of the seconded personnel plus a service fee mark-up of 10 percent over its actual costs. SWI also provided certain administrative support services to SII. For the secondment of personnel and administrative support services, SII paid SWI CA$2,058,049 and CA$2,811,892 in 2000 and 2001, respectively.

During 2000 and 2001, SWI purchased window products from Marzen Canada at a price equal to the sale price to customers, so that SWI recognized no profit on sales, but rather earned only a cost-based service fee from SII as discussed above.

Csumrik was also the principal of a Barbados corporation, Longview Associated Limited (Longview), which was engaged in establishing international business corporations in

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[6] It is important to note that after considering all the facts, Justice Sheridan concluded that this advice was not attributable to SII, but instead was provided by Csumrik "in his personal capacity directly to Mr. Martini/the Appellant." (*Marzen*, paragraph 138.)
[7] *Marzen*, *supra* note 1, paragraph 56.
[8] *Id.*, paragraph 60.

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Barbados and providing management and administrative support services (such as accounting and financial statement preparation) to arm's length corporate clients for an annual fee of US$30,000. Additionally, for an annual rate of US$2,500, Longview would provide Csumrik's personal services as managing director to Longview's corporate clients. Longview was not part of the Marzen Canada related group of companies.

With respect to the local business requirements in Barbados, SII engaged Longview to provide local management and administrative services for US$30,000 annually. Additionally, SII paid Longview US$2,500 annually for the services performed by Csumrik in his capacity as managing director of SII.

The minister's reassessment

The minister reassessed Marzen Canada's 2000 and 2001 taxation years, disallowing the deduction of any amounts in excess of the fees paid by SII to SWI. Quantitatively, the adjustment made by the minister was CA$2,110,502 for 2000 and CA$5,025,190 for 2001. The 2001 reassessment is particularly significant, as it exceeded the penalty threshold and the minister determined that contemporaneous documentation as required by subsection 247(4) of the Income Tax Act (Canada)[9] was not in place to mitigate or avoid the assessment of penalties under subsection 247(3).

Tax Court judgment

Justice Sheridan ruled that the arm's length amount that would have been paid by Marzen Canada to SII would be equal to SWI's costs paid by SII plus Longview's costs for Barbados management and administrative services and managing director services, rather than the marketing fees and one-time bonus marketing payment as claimed by Marzen Canada, or SWI's costs alone as per the minister's reassessment.

In reaching her decision, Justice Sheridan:

- Relied on OECD guidance;
- Accepted the CUP method analysis presented by the Crown as representative of the minister;
- Placed emphasis on the importance of SII's services (functions);
- Did not rely on Marzen Canada's expert witness report, which concluded that the transactional net margin method (TNMM) would generate the most reliable result using an "amalgam" approach that combined SWI, SII, and the all of the value added by Mr. Csumrik (whether such value was attributed to SII or not); and
- Determined that Marzen Canada did not make reasonable efforts to determine and use arm's length prices, and as a result Marzen Canada would be subject to penalties under subsection 247(3) of the Act, if the adjustments exceed certain thresholds.

[9] RSC 1985 c, 1 (5th Supp.), herein referred to as the Act.

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Interpretive usefulness of OECD guidance

In most tax jurisdictions globally, it is common practice for tax administrations to follow the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[10] when evaluating the income and expenses of a multinational taxpayer that is part of a controlled group. Given the international nature of transfer pricing, establishing a common framework followed in multiple tax jurisdictions helps to avoid confusion and potential double taxation that may result if different methods are applied to the same transaction by different tax authorities. While it is often taken for granted that the OECD guidelines are to be followed in any transfer pricing analysis between OECD member countries, the OECD guidelines do not have the force of law in Canada and, therefore, Canadian courts are not compelled to follow them.

Comments made in prominent Canadian transfer pricing cases seem to show inconsistent acceptance of the OECD guidelines by Canadian courts. For example, in *McKesson*, Justice Boyle's remarks show a certain level of skepticism: "OECD Commentaries and Guidelines are written not only by persons who are not legislators, but in fact are the tax collection authorities of the world. Their thoughts should be considered accordingly."[11] In *Marzen*, by contrast, the OECD guidelines are cast in a much more favorable light, as Justice Sheridan notes that "[b]ecause the *Act* is silent as to how to carry out the analysis contemplated by subsection 247(2), Canadian courts have endorsed the use of the OECD Guidelines. The OECD Guidelines do not have the force of law, but rather, are intended as tools to assist in determining what a reasonable business person would have paid if the parties to a transaction had been dealing with each other at arm's length."[12]

Interestingly, both justices rely on the SCC decision in *Glaxo* in arriving at their positions on the OECD guidelines. In this regard, it seems that Justice Boyle focused on paragraph 20 of the SCC judgment, which notes "the *Guidelines* are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to s. 69(2) rather than any particular methodology or commentary set out in the *Guidelines*." In *Marzen*, Justice Sheridan seemed to place greater emphasis on the fact that the SCC judgment later notes that the Act itself does not offer guidance as to how to determine the amount that would have been payable had the parties been dealing at arm's length, and goes on to discuss and rely on the OECD guidelines.

In cases that predate *Glaxo*'s SCC judgment, including the TCC decisions in *Glaxo*, *GE*, and *APCL*, the courts relied on the OECD guidelines as useful interpretive material, and all three judgements include references to the FCA decision in *SmithKline Beecham Animal Health Inc.*

[10] The OECD issued commentary on transfer pricing in 1979, which was updated in 1995 and again in 2010. As a practical matter, judges have typically referenced the most updated OECD guidelines that were available at the time the transactions at issue were entered into. For example, in paragraph 149 of *APCL* it was noted that "[t]here was a further update in 2010, but, since this update is well beyond the taxation years in issue, I will refer only to the applicable 1995 Commentary."

[11] *McKesson*, *supra* note 5, paragraph 120.

[12] *Marzen*, *supra* note 1, paragraph 177.

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v. Canada,[13] which notes "[i]t appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2) of the *Income Tax Act*."[14]

The decision in *Marzen*, consistent with most of the earlier jurisprudence, seems to suggest that although not legally binding – as noted especially in *McKesson* – the OECD guidelines are accepted by Canadian courts and are relied on to inform the interpretation and application of transfer pricing sections of the Act.

CUP method preferred by Canadian courts

The *Marzen* judgment adds to a growing body of Canadian case law in which the CUP method is chosen over other transfer pricing methods discussed in the OECD guidelines. While the CUP method is the most direct method to establish an arm's length price and is therefore often viewed by tax administrators, including the Canada Revenue Agency (CRA), as the preferred method when it can be reliably applied, it should be noted that the appropriate application of the CUP method requires a detailed analysis of all economically relevant circumstances, including but not limited to the comparability factors identified by the OECD guidelines.[15]

A major source of contention in Canadian case law surrounds the determination of factors that should be considered in a comparability analysis and the impact such factors may have on applying or making adjustments to the CUP method analysis. Considering the case-specific nature of identifying relevant comparability factors, it would be difficult to devise an all-encompassing list. However, Canadian case law seems to indicate that a very wide net should be cast when considering potential economically relevant factors.

CUP method preference

In *Marzen*, Justice Sheridan was persuaded that the CUP method was the reliable choice in this case. This is consistent with the TCC's *APCL* judgment, in which Justice Pizzitelli found that the CUPs identified were acceptable and preferred by available transfer pricing guidance. In the TCC's decision in *Glaxo*, both the taxpayer and the Crown relied on the CUP method to support their respective positions; the disagreement arose in respect of which comparable uncontrolled price to rely on, rather than which transfer pricing method to implement. *GE*'s judgment is consistent with this assertion, because even though the CUP method was not relied on, it was only after no CUP transactions were identified by either party that other pricing methodologies were considered.

Given the continued preference for the CUP method, taxpayers should be very thorough in their analysis of its applicability to their facts and circumstances, and be prepared for its potential application upon dispute.

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[13] 2002 FCA 229.
[14] *Id.*, paragraph 8.
[15] Comparability factors can be found in the 2010 OECD guidelines, paragraph 1.36.

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Appropriate comparability analysis is critical

As discussed above, while the CUP method is the preferred method when it can be applied reliably, it is critical to consider all economically relevant factors when assessing the reliability of potential comparable uncontrolled prices. In practice, when all factors are considered, it is not always easy to establish a reliable CUP. The 2010 OECD guidelines provide five “comparability factors” that may be important when determining comparability. 16 These factors are not exhaustive, but include:

- Characteristics of the property or services transferred;
- The functions performed by the parties (taking into account assets used and risks assumed);
- The contractual terms;
- The economic circumstances of the parties; and
- The business strategies pursued by the parties.

While *Marzen* is relatively limited regarding discussion of the comparability factors,[17] *APCL* and *Glaxo* offer more detailed analysis in this regard. Specifically, in *APCL*, the importance of the comparability factors was recognized by referencing the OECD guidelines and including the taxpayer’s expert witness’ comparability factors analysis in the judgment as Appendix A. Similarly, *Glaxo*’s TCC judgment specifically reviewed the criteria for the CUP method and contained a detailed analysis of the comparability factors.[18]

The SCC decision in *Glaxo* added to the comparability factors to be considered, highlighting the difficulty to establish a reliable CUP given the myriad case-specific economic circumstances that must be considered. Specifically, the SCC decided “[i]t is only after identifying the circumstances arising from the Licence Agreement that are linked to the Supply Agreement that arm’s length comparisons under any of the OECD methods or other methods may be determined.”[19] Thus, the SCC did not endorse or preclude the CUP method, but rather added a consideration that is critical for the analysis, while leaving it again to the TCC to judge the ultimate determination of the arm’s length price. *GE* also highlights the need to diligently consider all factors in a comparability analysis (albeit not specifically in the context of a CUP method analysis), as the FCA in *GE* confirmed that no error in law was made in taking into consideration that the appellant, as a subsidiary of its larger parent company, had an implicit guarantee by its parent of its bank debts.

In determining whether the CUP method is the most reliable method, and whether comparability adjustments are necessary, taxpayers must consider the difficulty in its application where differences exist between controlled and uncontrolled transactions or

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[16] These same factors are included in the 1995 OECD guidelines, paragraph 1.17, as “Attributes that may be important.”
[17] It seems that the CUP method was accepted after rejecting the TNMM analysis presented by Marzen Canada’s expert witness, rather than going into extensive detail accepting the CUP method.
[18] In addition to the five comparability factors noted above, paragraph 119 of *Glaxo*’s TCC judgment includes comparability of point in the chain where goods are sold.
[19] *Glaxo*, SCC, *supra* note 2, paragraph 60.

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between the enterprises undertaking those transactions. As with any method, the reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.[20] Ultimately, as transfer pricing is not an exact science, the choice of methodology for establishing arm's length pricing will not often be unambiguous.[21]

Importance of properly determining economic profiles

In this case, the taxpayer attempted to minimize its global effective tax rate by establishing SII in Barbados. While multinational entities can establish related parties in any jurisdiction, including jurisdictions with lower tax rates, taxpayers must carefully consider what would be agreed to at arm's length when transacting with such related parties. An important part of this determination includes an analysis of the "economic profile" of the respective entities, which includes an analysis of the risks borne, assets utilized, and functions performed.

While economic profile analyses must always consider risks, assets, and functions, it appears greater emphasis is being placed on appropriately considering the *functions performed* by the respective entities in the context of the controlled transaction. The emphasis on functions can be seen in the OECD's base erosion and profit shifting (BEPS) initiatives as well as decisions in recent Canadian court cases involving transfer pricing.

Justice Sheridan agreed with the application of the CUP method put forth by the Crown's expert witness that attributed no profit to SII based on the conclusion that "SII performed no functions on behalf of the Appellant under the MSSA other than those provided on its behalf by SWI and Mr. Csumrik/Longview."[22] In reaching this conclusion, Justice Sheridan also noted that SII "was an empty shell with no personnel, no assets and no intangibles or intellectual property,"[23] and accepted the Crown's position that SII's activities lacked sufficient substance to support the income it earned and the entity was "a flow-through entity or facilitator that makes the services of others available to the Appellant."[24]

One lesson to be learned from the determination that SII was an empty shell is that taxpayers should consider all clauses of legal agreements very carefully and ensure that risks are clearly borne by the party intended to bear those risks. In this case, it appears that Justice Sheridan was able to reach the conclusion that SII was risk-free based on the MSSA, which provides that "[u]nder Clause 3.2, the Appellant also agreed to advance to SII 'such reasonable amounts as may be requested by SII from time to time' to assist SII with the costs of providing its services."[25]

However, SII was responsible for making payments to SWI based on SWI's *costs* under the PSA and payments to Longview based on a predetermined annual rate. SII's income under the MSSA, on the other hand, was determined in reference to *sales*. Therefore, setting aside the potential implications of Clause 3.2 noted above, in an economic scenario in which sales fall

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[20] OECD guidelines 2010, paragraph 2.16.
[21] *Id.*, paragraph 4.8.
[22] *Marzen*, *supra* note 1, paragraph 205.
[23] *Id*, paragraph 136.
[24] *Id.*, paragraph 140.
[25] *Id.*, paragraph 55.

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and the marketing fee does not cover SWI's costs and Longview's fees, SII could in theory incur losses and, therefore, bears a certain degree of commercial success risk.[26] Of course, if it were determined that SII legally and contractually bore the commercial success risk, the necessary next step of a complete risk analysis would be to consider whether SII actually had the economic capacity to bear such risk, including whether SII could control the risk, and whether SII had the financial capacity to assume that risk. Since Clause 3.2 seems to have allowed for the conclusion that SII was risk-free, detailed analysis regarding the economic capacity to bear risk was not fully developed in the facts before the court.

In theory, one could further debate the impact of Clause 3.2 on SII's contractual risk. It appears to be assumed that Marzen Canada would advance to SII any amounts requested – presumably on the grounds that SII and Marzen Canada are related. However, an arm's length analysis must construct a transaction in which neither party controls the other, and each party acts as an arm's length participant would act.[27] The authors do not contend that this was not taken into consideration in this decision, nor would it necessarily materially affect the price or outcome, but merely emphasize that referring to SII as "risk-free" based on Clause 3.2 could be subject to further debate given the clause does not seem definitive regarding what amounts are "reasonable" to request, and arm's length parties would not necessarily advance any and all amounts requested. Again, taxpayers are cautioned to consider the potential interpretation of clauses in intercompany agreements and their possible impact on an analysis of the entity's economic profile.

Based on the evidence before the court, Justice Sheridan found that there was no value attributable to SII itself, and agreed with the Crown's CUP method analysis, which did not attribute any profit to SII. It should be reiterated that this decision does not indicate in any manner that the courts disagree with taxpayers' organizing their operations in a tax-efficient manner. On the contrary, the courts have often highlighted the fact that multinational corporations are legitimately able to maximize after-tax profits by minimizing their global effective tax rate. For example, Associate Chief Justice Rip notes in the *Glaxo* TCC decision that "[t]here is nothing obscene or objectionable in a taxpayer making as much profit as possible and to make legitimate efforts to pay minimal tax on the profits and I draw no negative conclusion in a taxpayer doing so."[28] Justice Sheridan echoes this sentiment in *Marzen*, noting "I recognize that the Appellant is entitled to organize its commercial operations in a tax effective manner."[29]

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[26] It is also worth noting that based on the facts, it would appear that commercial success risk regarding the U.S. market was borne outside Canada prior to SII's operations as well, considering the losses incurred by SWI prior to the years under analysis.
[27] Similar logic is applied in the Appellant's Memorandum of Fact and Law in *McKesson*, which relies on *Glaxo* and *GE* when asserting that "in no case should the fact that the parties belong to the same corporate group, much less the fact that one controls the other, inform the application of transfer pricing rules to the dealings between them. That would be the antithesis of the arm's length principle, the object of which is to determine an arm's length price as if the related parties were in fact unrelated and entered into the same transaction."
[28] *Glaxo*, TCC, *supra* note 2, footnote 6 to paragraph 13.
[29] *Marzen*, *supra* note 1, paragraph 156.

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Profit maximization strategies must respect tax rules and guidelines, however, and the courts place significant emphasis on the functional profile of the respective entities and expect taxable earnings to be commensurate with the respective roles and functions of the related parties in the context of the controlled transactions. For example, *Glaxo*'s SCC judgment highlights the importance of the respective functional profiles of related parties, observing that "Glaxo Canada engaged in the secondary manufacturing and marketing of Zantac. Glaxo Group is the owner of the intellectual property and provided other rights and benefits to Glaxo Canada. *Transfer pricing should not result in a misallocation of earnings that fails to take into account of these different functions and the resources and risks inherent in each*."[30] Canadian jurisprudence indicates that legal relationships between Canadian entities and related parties in low-tax jurisdictions will be respected. However, the entities in low-tax jurisdictions must have sufficient substance (such as bearing risks, performing functions, or utilizing assets) to justify the arm's length nature of the price paid, which must be highly correlated with value creation.[31]

Marzen highlights the need for taxpayers to carefully consider the functions of related parties in a multinational group when organizing global operations in a tax-effective manner. Of course, one cannot ignore assets and risks as relevant factors to be considered when determining an entity's comprehensive economic profile, but the factors are interrelated, with emphasis recently being placed on functions in conjunction with consideration of risks and assets. As such, taxpayers should establish a functional profile that supports that entity's ability to control risks[32] (in addition to contractually bearing risks), and a functional profile that supports that entity's ability to manage or control value-creating activities related to assets[33] (in addition to legally owning assets).

"Entity-by-entity" or "transaction-by-transaction" analyses must consider all economically relevant circumstances

In *Glaxo*, there was much debate surrounding whether a transfer pricing analysis must limit its scope to the transaction at hand, or whether it is possible to deviate from the preferred "transaction-by-transaction" approach by considering other transactions if appropriate in the circumstances. The SCC confirmed that all economically relevant circumstances that would be

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30 *Glaxo*, SCC, *supra* note 2, paragraph 62, emphasis added.

31 For example, Actions 8, 9, and 10 of the OECD's Action Plan on Base Erosion and Profit Shifting aim to "Assure that transfer pricing outcomes are in line with value creation" demonstrating an explicit focus on emphasizing the correlation between transfer pricing and value creation.

32 2010 OECD guidelines, paragraph 9.23 notes that ""control" should be understood as "the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk" indicating the link between functions (decision making) and risks.

33 For example, paragraph 77 of the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles released July 30, 2013, notes, in respect of the legal owner of intangible assets, the need to consider functions when considering benefits attributable to assets; specifically, "if it neither controls nor performs the function, the legal owner likely would not be entitled to any ongoing benefit attributable to the outsourced functions."

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considered by arm's length parties must be considered, including other transactions if such transactions are economically connected or linked.

In *Marzen*, the taxpayer's expert report combined SWI and SII and Csumrik's contributions (which were not always clearly defined or attributed to a particular entity) into an "amalgam," and utilized the TNMM to assess the arm's length pricing of the Marzen Canada payments to SII by testing the net profit results of the amalgam against comparable third-party enterprises. Justice Sheridan rejected this "amalgam" approach and agreed with the Crown's expert witness that SWI and SI should not be treated as one entity.

Justice Sheridan's rejection of the "amalgam" approach in favour of the Crown's CUP approach, which purports that "the arm's length principle requires an entity-by-entity approach to a transfer pricing analysis,"[34] brings to mind the *Glaxo* journey through the Canadian courts, which focused largely on whether a "transaction-by-transaction" approach is more correct, or if other separate agreements should form part of the consideration in determining the arm's length amount. In *Glaxo*, at the TCC level, Associate Chief Justice Rip concluded that the two agreements in question "cover separate matters and that they are to be considered independently…One cannot combine the two transactions and ignore the distinct tax treatments that follow from each."[35] Justice Nadon (writing for a unanimous panel) disagreed in the FCA judgment, and instead concluded that "[b]ecause it was central to the appellant's business reality, and would be so if it were dealing at arm's length with Adechsa, the License Agreement with Glaxo Group was 'a circumstance' which had to be taken into account by the Judge."[36] On appeal by the Crown, the SCC agreed with the FCA, and Justice Rothstein, relying on the interpretive usefulness of the 1995 OECD guidelines, noted that "[w]here there are no related transactions or where related transactions are not relevant to the determination of the reasonableness of the price in issue, a transaction-by-transaction approach may be appropriate. However, 'economically relevant characteristics of the situations being compared' may make it necessary to consider other transactions that impact the transfer price under consideration."[37]

It is interesting to note that *Glaxo* did not contemplate the "entity-by-entity" considerations that were discussed in *Marzen*, despite the fact that the two transactions considered throughout *Glaxo*'s "transaction-by-transaction" debate were with two separate entities in two distinct tax jurisdictions[38] – not unlike the facts in *Marzen*. It should further be noted that although *Glaxo* ruled that all economically relevant characteristics of the situation must be considered, including other transactions with other entities, an "amalgam" approach was not explicitly endorsed.

A Notice of Appeal was filed regarding the *Marzen* decision on September 5, 2014, and it remains to be seen whether the appeal to the Federal Court of Appeal will result in different

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34 *Marzen, supra* note 1, paragraph 125.
35 *Glaxo*, TCC, *supra* note 2, paragraph 78.
36 *Glaxo*, FCA, *supra* note 2, paragraph 78.
37 *Glaxo*, SCC, *supra* note 2, paragraph 42
38 The two transactions were: a license agreement between Glaxo Canada and Glaxo Group Limited, a UK corporation, and a supply agreement between Glaxo Canada and Adechsa S.A., based in Switzerland.

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interpretation as to the applicability of the amalgam approach. It also remains to be seen what "considering" the license agreement will mean when the TCC redetermines supply agreement prices in *Glaxo*, as instructed by the FCA and SCC. At this point, the evolving guidance from Canadian jurisprudence indicates that a wide net should be cast when considering economically relevant circumstances, including other transactions that impact the business reality of the Canadian taxpayer. However, this does not give taxpayers carte blanche to ignore legal relationships. Legal relationships should be respected, and amalgamating and pricing combined groups of transactions and entities should be undertaken with due care and caution.

Taxpayers must respect administrative requirements

Marzen Canada was assessed penalties by the minister because the original 2001 adjustment of CA$5,025,190 exceeded Canada's transfer pricing penalty threshold of the lesser of (1) 10% of gross revenue for the year; and (2) CA$5 million, and because the minister concluded that Marzen Canada did not make reasonable efforts to determine and use arm's length transfer prices as required by subsections 247(3) and (4) of the Act.

Ultimately, it does not appear that penalties will apply, as Justice Sheridan allowed additional payments of US$32,500 to reduce the adjustment imposed by the minister to below the threshold noted above.

Nevertheless, Justice Sheridan addressed the issue of penalties and the Act's "reasonable efforts" requirement to determine and use arm's length transfer prices. Marzen Canada's defense in respect of penalties was that its response to the CRA's request for contemporaneous documentation evidencing that the reasonable efforts requirement had been met included the statement "[i]f you need any elaboration on the enclosed material please don't hesitate to give me a call," adding that the CRA never asked for clarification. Justice Sheridan dismissed this defense, and found that Marzen Canada had not made reasonable efforts to determine and use arm's length transfer prices.

While Marzen Canada may narrowly fall short of the penalty threshold, the case highlights the need for taxpayers to respect the documentation requirements contemplated under section 247 of the Act when making reasonable efforts to determine and use arm's length transfer prices. Taxpayers should be aware that commentary in *Marzen* as well as *McKesson*[39] may embolden the CRA to expand the frequency with which transfer pricing penalties are assessed. It should also be noted that the CRA has not been deterred from pursuing (relatively) smaller disputed amounts – with court cases ranging from tens of millions in *Glaxo* to just over $1 million per year in *APCL*. Relatively small multinational Canadian taxpayers should not assume they are not required to document their efforts to determine and use arm's length prices, but should instead consider the case law, which has shown on multiple occasions that relatively small transactions may be scrutinized, and that the courts expect

[39] Justice Boyle noted in footnote 20, "it appears to me that CRA may need to review its threshold criteria with respect to subsection 247(4). I would not have expected last minute, rushed, not fully informed, paid advocacy that was not made available to the Canadian taxpayer and not read by its parent, could easily satisfy the contemporaneous documentation requirements."

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contemporaneous documentation to be robust and complete regardless of the size of the taxpayer.

Conclusion

Marzen is an interesting addition to Canadian transfer pricing case law, reaffirming certain tenets established by Canadian courts, including the reliance on the OECD guidelines, the importance of appropriate consideration for the CUP method, the position that the functional roles of the respective entities should accord with the transfer prices used, and the importance of adhering to administrative requirements. *Marzen* is also especially relevant and useful when considering amalgamating transactions and entities in a transfer pricing analysis and the requirements of "reasonable efforts" to establish and use arm's length prices.

Marzen demonstrates that taxpayers should consider the heightened focus on functions performed by the respective related parties, particularly given the interrelated nature of functions, assets, and risks. One can also learn from *Marzen* that taxpayers should carefully consider potential interpretations of clauses in intercompany agreements, and what impact such clauses may have on an analysis of the entity's economic profile. Given the practical difficulty in foreseeing all potential disagreements, and having regard to the fact that transfer pricing is not an exact science, transfer pricing disputes are inevitable. Because the Canadian transfer pricing penalty is ultimately a compliance penalty, rather than an accuracy penalty, *Marzen* also highlights the importance of appropriately documenting reasonable efforts to obtain and use arm's length prices to mitigate transfer pricing penalty risk.

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