

## Transfer Pricing

# BEPS: Implementation of Transfer Pricing Changes (Part 1: Australia, Japan, China, and Korea)

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# Agenda

As the OECD / G20 BEPS project has moved into the implementation phase, we will provide an update of domestic legislative activities and timelines to incorporate the various BEPS transfer pricing changes into specific domestic tax regimes

We will also cover harmonization efforts for transfer pricing documentation rules and requirements from local perspectives.

Today, our focus will be on Australia, Japan, China, and Korea

Part 2: South East Asia and India focus

# Poll question 1

Does your organization operate in which of the following countries?

- China
- Australia
- Japan
- Korea
- Three countries or more
- None of the above

# China

# China – domestic framework

## Revised Circular 2

- China released a draft of its revised transfer pricing regulations on 17 September 2015, even before the final BEPS reports were issued
- Key changes in the revised regulations
  - New requirements for contemporaneous TP documentation: Chinese TP local documentation required to include all the contents of master file, local report and report on special matters including cost sharing and thin capitalization. Country by Country (CbC) reporting not part of China documentation requirement for MNCs with inbound investment into China but China-based HQ meeting the threshold are required to disclose the CbC information on their annual corporate income tax returns
  - New chapters for Intangibles and Inter-company Services: largely incorporates OECD comments for intangibles, as well as formalizing the Bulletin 16 requirements into the main TP regulations
  - New TP methods introduced: includes new value creation method, which may be used to allocated more of global supply chain profits to the contributions made by China entities. This will be possible to apply with the extensive information requirements for documentation with the combined requirement on disclosing the supply chain details
- Comments were due by 16 October 2015
- Finalized rules are expected by end of 2015

# Australia

# Background

- Australia supportive of BEPS agenda from inception
- Change to leadership of Australian Government
- What does that mean for Australia's approach for BEPS
  - No change in broad agenda, BEPS fully supported
  - Might see change in Australia's enthusiastic leadership of items
  - More watching global partners actions and keeping Australia inline
- Australia introduced new legislation in 2013 which incorporate OECD guidance into the Australian transfer pricing law
- Laws to enable implementation of some elements of BEPS actions are currently going through the parliamentary process
  - CbC reporting
  - Multinational anti avoidance legislation
  - Penalties

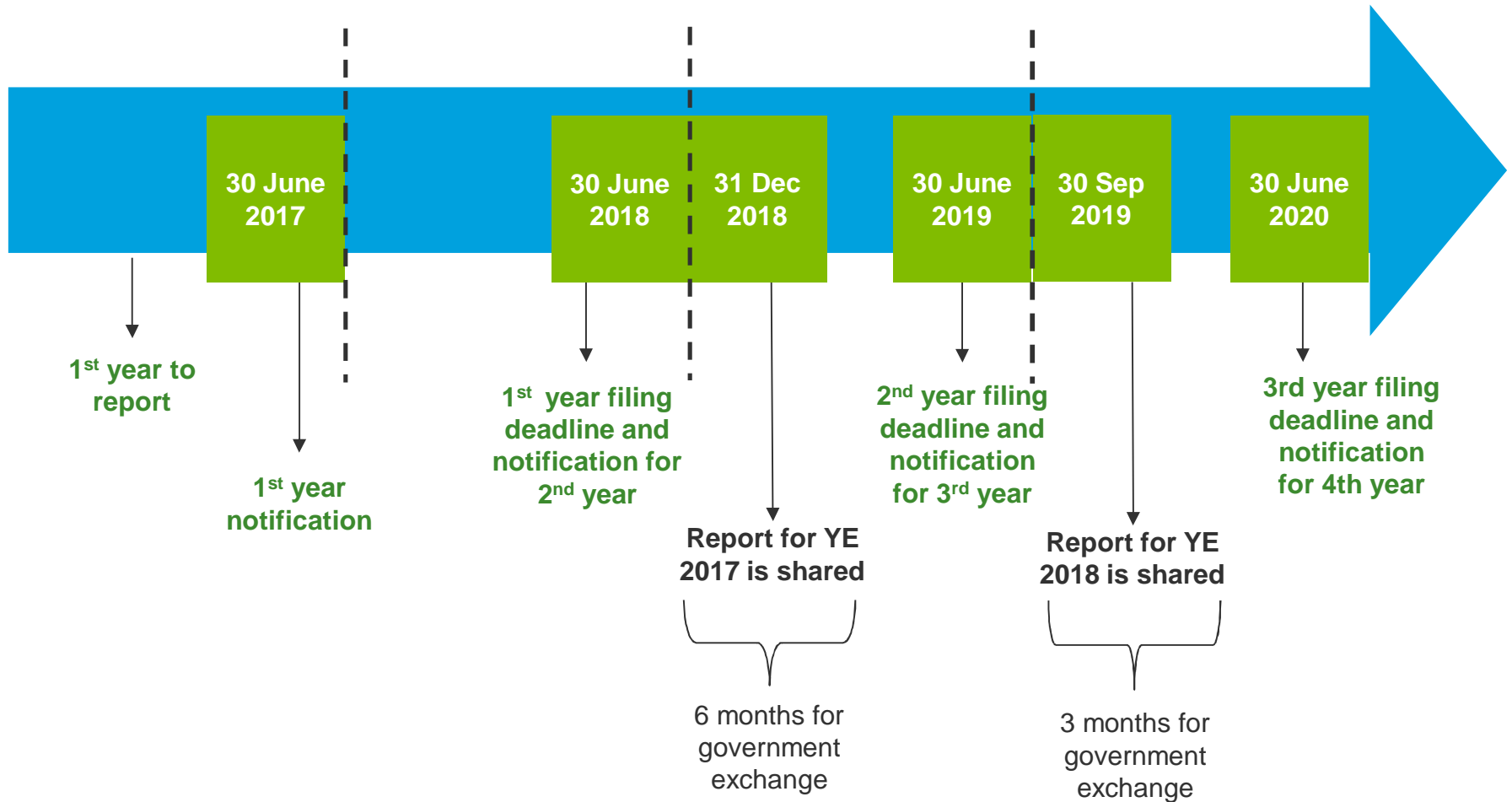
# Australia

## Update CbC reporting

- CbC reporting
  - As reported in the 2015-16 Australian Federal Budget, the OECD's new transfer pricing documentation standards (BEPS Action 13) will be implemented from 1 January 2016
  - Bill to support full implementation is currently still before parliament
    - Has full support of Parliament however held up by debate on other measures included in the same Bill
  - ATO presently looking to publish CbC guidance before start date Jan 2016
    - Likely to take a pragmatic administrative approach linked to obligations in country of residence of Parent
    - Should provide clarity on differences between OECD (local file) and domestic S284E obligations



# Australia Timeline



# Australia

## Update tax secrecy and transparency initiative

- Tax secrecy and transparency: administrative arrangements for reporting entity information
  - ATO to report limited tax data for companies with turnover >A\$100m
  - Debate in Parliament
    - Initially only Public companies
    - Amendment suggested to include private companies
    - Government is not supportive of the amendment
    - Further debate to ensue

# Japan

# Japan – domestic framework

- Generally, Japanese tax authority will follow all of the OECD deliverables in legislation or guidelines in Japan or just referring the deliverables
- Broad guidelines of tax revisions this year will be disclosed in mid to late December 2015, and the main topic would be related to Action 13, TP documentation requirement
- Legislation based on deliverables of Action 13 is expected to be applied on fiscal years starting after April 2016. Below file / reports are currently in draft stage
  1. **MF:** Must be prepared / submitted, **Deadline of submission:** a year after fiscal year end (by March 2018 for FYE March 2017), **Acceptable language:** Japanese or English, **Penalty:** under consideration
  2. **CbC reporting:** Must be prepared/ submitted, **Deadline of submission:** a year after fiscal year end (by March 2018 for FYE March 2017), **Penalty:** under consideration
  3. **LF:** Must be prepared/ available, **Deadline of documentation:** tax return due date (June 2017 for FYE March 2017), **Acceptable language:** Japanese or English, **Penalty:** possibility of presumptive assessment
- The legislation will come into effect in April 2016

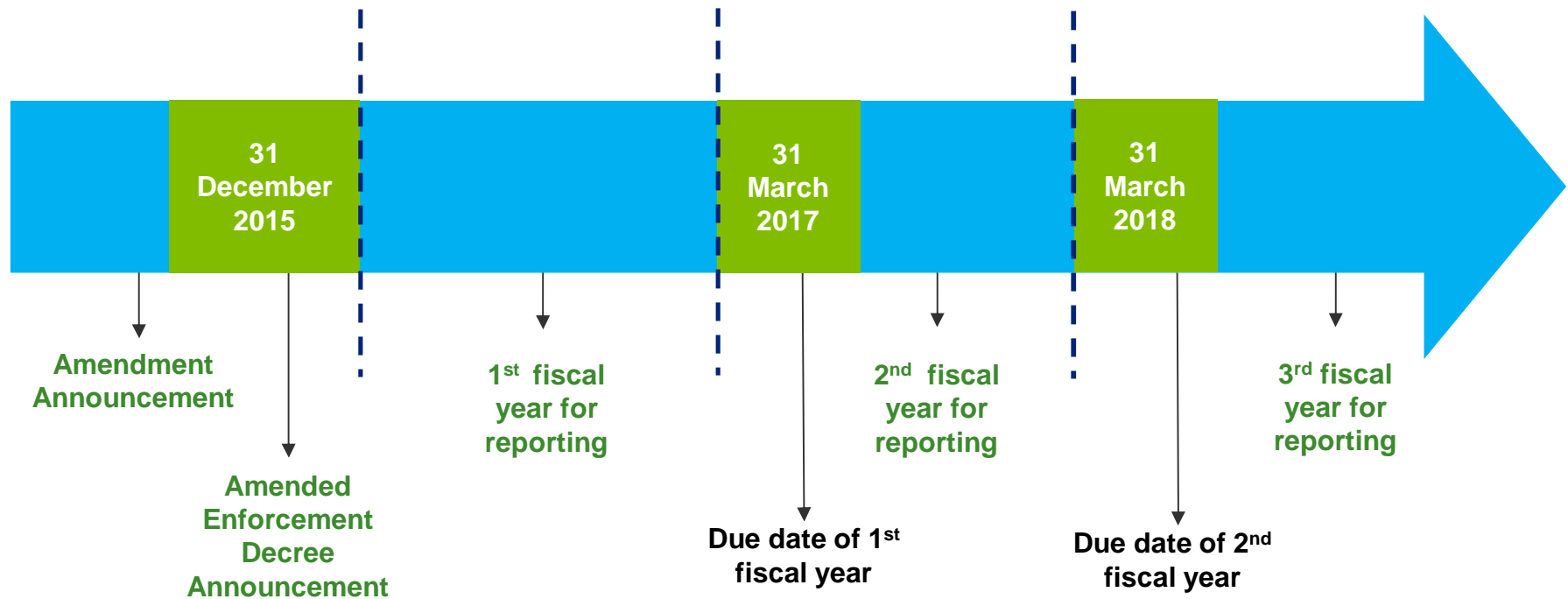
# Korea

# Korea – domestic framework

- Amendment on TP documentation rules
  - The Ministry of Strategy and Finance (MOSF) announced in August 2015
  - Focus is on Action 13
- Key features of amendment
  - MF & LF
    - Submission required for taxable year 2016
    - Effective date: a new taxable year starting from 1 January 2016
    - First “submission” due date: tax return due date, e.g., 31 March of the following year for a calendar year end company
    - Penalty for no submission: KRW10 million
    - Detailed guidance: expected December 2015 and early 2016
- *CbC reporting: not required for taxable year 2016 but expected in 2017*

# Korea

## MF/LF timeline



- MF/LF (Comprehensive TP Report) will be legislated first
- Cbc report is expected to be implemented in 2017 according to MOSF

# Poll question 2

What best describes your company's approach for responding to BEPS transfer pricing implications?

- Primarily focusing on documentation
- Analyzing existing transactions in light of the changes
- Waiting to see how and when the U.S. will change its rules
- Don't know / not applicable



# Intangibles

# Intangibles

## Determining intangibles-related return

Step 1: Identify the intangibles with specificity

Step 2: Identify the contractual arrangements

Step 3: Identify parties performing important functions

Step 4: Confirm conduct of the parties consistent with contracts

Step 5: Delineate the actual transactions

Step 6: Determine the arm's length price for the transactions

# Intangibles

## Japan

- Japanese tax authority appreciates the outcome of the Action plans relating to intangibles and will revise the TP guidelines in Japan to comply with the concepts in several years and/or just refer to the deliverables of the BEPS Actions
- As for the Hard to Value Intangibles, Japanese tax authority is considering to implement a new legislation on commensurate with income rules not in 2016 but in 2017 or after
- Companies in Japan have to re-examine the intangibles based on the outcomes of the BEPS Action plans

# Intangibles

## China

- A new Intangibles chapter has been added to the revised TP rules
- There are a lot of similarities to the OECD regulations, although some difference still exist
- Location Specific Advantages are mentioned in the Chapter for Intangibles and also in the Chapter of investigation. China SAT tends to take more practical view to focus on the economic value to be brought through LSAs rather than to argue whether LSAs are intangibles or not
- Legal and economic ownership identified: Parties playing DEMPE functions are classified as economic owners, entitled to profit appropriation. A mere legal owner with no DEMPE functions and bearing no risks cannot enjoy profit
- Cash box: only entitled to routine return on provision of fund
- When determining reasonable profit attributable to a China taxpayer, a comprehensive analysis taking the taxpayer's contribution to the supply chain, share of group intangibles, LSAs and group synergy into account should be performed
- Benefit test: important to both royalties and service fee payments

# Intangibles

## Korea

- No amendment announced on guidance on intangibles
- Revision to Chapter 6 of OECD Guidelines is one of the most significant changes adopted by OECD/G20 members
- MOSF has adopted the recommendations of the OECD for the most part, when recommendations have been made
- In practice, one of the most challenging areas will be business restructuring
  - For companies going through business restructuring frequently, important to note that Changes in contractual allocations of risks will be challenged without actual changes in economic substance
    - For example, with little changes in actual business operations and consequently little changes in the functions performed, assets used, and risks assumed, the case will be very hard to support only with contractual allocations of risks

# Intangibles

## Australia

- The ATO has long been looking at issues involving intangible property
- A couple of key points to note re the changes
  - There is an intention to align pricing outcomes with value creation and
  - Legal ownership alone does not necessarily give you the right to a return from exploitation
- With BEPS actions, It is not expected that there will be any change to Australia's approach

# Value chain analysis

# Value chain analysis

## Context and the “big picture”

- Fundamental changes
  - Importance of **two-sided analysis**
  - Support for any **“residual”**
- Functional analysis
  - **Functions** (people)
  - Important functions for intangibles - **development, enhancement, maintenance, protection, and exploitation**
  - Risks – **capability, functional performance, and financial capacity**
- Recognition of the **“accurately delineated”** transaction
- Re-emphasis on **functions performed, assets used, and risk incurred**



# Korean implications

- Analysis of value chain and profit drivers would require much deeper understanding of industry, business, global and relevant local economic environments
- Challenges
  - Administrative burdens for companies with business restructuring involving significant changes in operational activities where value chain activities are subject to frequent changes
  - Hard to demonstrate without proper documentation what is planned with important changes when they are planned initially, many years later when an inquiry begins
  - Tax authorities will have much more and detailed information about value chain and profit drivers, not to mention sufficient time to analyse them, before they challenge inconsistencies they might find

# China implications

- New “Value Creation” method, as an example method under “other methods”, is China’s proposed solution to profit splits for tax aligned supply chains. SAT is likely to focus increasingly on Chinese contributions to the profits
- More disclosure requirement on supply chain flow in which the China taxpayer participates
- Other economic factors such as intangibles’ economic ownership, LSAs and group synergy need to be taken into consideration

# Japanese implications

- Japanese tax authority follows the related OECD deliverables but no specific discussion has been taken place for Value Chain Analysis
- Japanese companies need to analyze value chain in order to prepare consistent Master file and Local files anyway

# Australia – Multinational Anti Avoidance Legislation (MAAL)

- The MAAL, introduced into Parliament in September 2015, is still expected to be operative from 1 January 2016
- Is currently being debated in parliament
  - Like the CbC law, MAAL is supported but is being held up by debate on other measures included in the same Bill
- Commentary states **“The MAAL is designed to counter the erosion of the Australian tax base by multinational entities using artificial and contrived arrangements to avoid the attribution of profits to a permanent establishment in Australia”**
- A feature of the MAAL is that it can apply where “a principal purpose” is to obtain an Australian and / or a foreign tax advantage

# Australia – MAAL

- Applies to significant global entities
  - Turnover >A\$1bn
- Covers structures where O/S company sells direct to third party customers
- A related entity in Australia performs some functions in relation to supporting the sales into Australia
- ATO is due to Publish Guidance today covering
  - Technical Interpretation
  - Legislative aspects
- ATO also looking to publish guidance on a roadmap for self assessment and obtaining certainty

# Australia – penalties

## Failure to lodge the CbC Reports

- Will not prevent an entity from having a RAP in respect of its transfer pricing arrangements if its transfer pricing documentation is still maintained in accordance with existing requirements

## Other penalty guidelines for taxpayers

- Increased penalties apply for entering into tax avoidance or profit shifting schemes (now up to a maximum penalty of 120%)
- No increase in penalties where the company has a RAP

Culpable behaviour	Base penalty amount	Aggravating factors apply	Disclosure during examination	Disclosure before examination
Tax Avoidance Schemes	100%	120%	80%	20%
[if RAP]	[25%]	[30%]	[20%]	[5%]
Profit Shifting Schemes	50%	60%	40%	10%
[If RAP]	[10%]	[12%]	[8%]	[2%]

# Poll question 3

In your transfer pricing audits, have the tax authorities asserted positions based on the principles of the BEPS transfer pricing deliverables?

- Yes
- No
- Not applicable as no TP audit has occurred recently

# Risk and recharacterization



# Technical update 2

## Risk and recharacterization

Areas	Comments
<b>Delineation</b>	<ul style="list-style-type: none"><li>• Delineation of the actual transaction</li><li>• <b>Conduct trumps contractual arrangements</b></li></ul>
<b>Control over risk</b>	<ul style="list-style-type: none"><li>• <b>Capability</b> (competence) and <b>functional performance</b> (decision-making)</li><li>• Management of risk may be <b>outsourced</b></li></ul>
<b>Financial capacity to bear risk</b>	<ul style="list-style-type: none"><li>• Ranks equally with control</li><li>• Access to funding</li></ul>
<b>Non recognition (recharacterization)</b>	<ul style="list-style-type: none"><li>• Recognize actual transaction where <b>commercial rationality</b> and assessment of the <b>perspectives of options realistically available</b></li></ul>

# Risk and recharacterization

## Australia

- Australia has long had published guidance on business restructures
- Has long thought they could reconstruct a point not accepted outside ATO
- As with most things, likely that a reconstruction case will ultimately be litigated

# Risk and recharacterization

## China

- Examples of recharacterization: conversion of toller into contract manufacturer to change the cost accumulation, change of tested party, etc.
- Potential for double taxation
- China: compliance with TP documentation requirements will be a challenge for many companies. Strategies need to be established for the level of information that is provided. New TP method and increased focus on supply chains means structures may need to be revisited to ensure there is adequate substance in principal companies

# Risk and recharacterization

## Japan

- Japanese tax authority follows the related OECD deliverables but no specific discussion has been taken place for risk and recharacterization
- Japanese companies need to reconsider risks associated with its business and strengthen support through documentation, APA or other measures

# Risk and recharacterization

## Korea

- No announcement / guidance on how to deal with risk
- Tax authorities will consider, in a holistic manner, contractual allocation of risks (between the related parties), actual activities of related parties with consideration of ability to control and manage operations, capacity to control risk operationally and assume risk financially
- Tax authorities will determine whether to recognize and respect the substance
  - If actual conducts does not support what contract says, non-recognition rule kicks in and tax authorities would re-characterize the transactions based on actual conducts
  - For example, taxpayers need to make sure that a **capital-funding only** entity is allocated the appropriate profit commensurate with the corresponding level of risk if the entity does **not actually control / manage** the risks
  - In other words, taxpayer **with actual control of risk and financial capacity to assume risk** are **entitled to an excess profit as opposed to** a routine profit that is appropriate for the relatively low level of risk
- In business restructuring cases, tax authorities are always suspicious of the level of profit to entity performing control function without financial capacity to assume risk and is most likely to challenge a change in the level of profit, in particular, where the profit shifts to an overseas entity with a mere transfer of control of risk

# Questions & Answers



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