

# **International Taxation Conference**

## **Recent developments in Transfer Pricing**

**Mumbai, 2 December 2005**

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1. Developments in transfer pricing dispute resolution
  - A. MAP
  - B. Arbitration
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# I. DISPUTE RESOLUTION

## Main Dispute Areas

1. Administrative and managerial services/shareholder costs
2. Inter-company financing
3. Sales of finished goods
4. Intangibles/royalty rates
5. Technical services
6. Cost sharing (technology)
7. Commission for sales
8. Sale of raw materials

\* Source: Ernst & Young Transfer Pricing Global Survey 2003

## A. Mutual Agreement Procedure

### Art. 25(1) OECD Model

- Specific case agreement:
  - “actions of one or both of Contracting States”
  - “result or will result ( ) in taxation not in accordance with provisions of Convention”
  - “irrespective of remedies provided by domestic law ( )”
  - “present case to competent authority of residence State ( )”
  - “must be presented within three years from the first notification ( )”
- Pending litigation on same matter is no reason to refuse or defer MAP (Commentary § 23)
- Originally only ex-post procedures; currently: MAP-bilateral APA (ex ante)

## Mutual Agreement Procedure

### Art. 25(2) OECD Model

- “Competent authority shall endeavour ( ) to resolve the case by mutual agreement with the competent authority of other Contracting State with a view to the avoidance of taxation which is not in accordance with the Convention”
- Not in accordance: economic (in case of PE: juridical) double taxation, see Article 9(2) OECD Model
- “Any agreement reached shall be implemented notwithstanding any time limits in the domestic law ( )”

## Problems with MAP

- No guaranteed solution: “endeavour”
- Taxpayer not involved in negotiation process
- Revenue aspect is important to competent authorities
- Duration of procedure:
  - traditionally long in Europe; since 1995 acceptable duration because of Arbitration Convention
  - UK - US “Fast-track procedure”
- Interest may be charged

## Mutual Agreement Procedure

EU research into MAPs during 1995 - 1999:

- 413 transfer pricing cases referred to MAP by EU Member States, of which 127 intra EU
- Overall success rate 85% for MAPs concluded within EU
- Average processing time: 20 months(!)

# Mutual Agreement Procedure

## OECD efforts to improve functioning

- OECD Report 1984 (“Three Taxation Issues”)
- OECD Report 27 July 2004
  - access to MAP
  - suspension of tax collection (no conclusion)
  - interest on unremitted tax in dispute (no conclusion)
  - functioning of MAP: e.g. importance of common points of departure for recurrent cases
  - supplementary dispute resolution (advisory opinions, joint commission, arbitrations)

# Mutual Agreement Procedure

Canada

Guidance on Competent Authority Assistance under Canada's Tax Convention,  
1 January 2005

- procedural matters, including how to present and document a competent authority case
- interaction of MAP and domestic appeals
  - access to both forms at same time
  - taxpayer has to preserve access
  - appeal to be put on abeyance

# Mutual Agreement Procedure

## Canada-United States

MOU on mutual agreement procedure (3 June 2005)

- principle: resolution of cases of double taxation contrary to treaty should be possible in all cases
- administrative policies, practices and procedures should not delay or impede MAP
- OECD Guidelines will be followed
- further MOU to be prepared on procedure to determine facts; on how to solve specific problems; on procedural obstacles: and on notification requirements

## Brazil

### Brazil-German tax treaty expiring end of 2005

- disagreements on transfer pricing, because of fixed margins in Brazil
- in particular in pharmaceutical sector
- difficult to justify Brazil margin by taxpayers to other tax authorities
- MAPs almost impossible

## B. EU Arbitration Convention

- Signed 23 July 1990
- In force from January 1995 until 31 December 1999
- Re-entered into force on 1 November 2004 with retroactive effect from 1 January 2000 (for 15 “old” EU Member States)
- Now effective until 2010
- Six months before expiration Member States must agree on re-extension of Convention
- New Member States: ratification of Accession Protocol expected before end of 2005

## EU Arbitration Convention

Phase 1: MAP

Phase 2: -- (if no agreement within two years after submission of case):  
setting up of Advisory Commission  
-- AC must deliver opinion within 6 months

Phase 3: -- Competent Authority must decide within 6 months after  
delivery of opinion by AC  
-- Competent Authorities may deviate from opinion AC  
-- if no agreement: adoption of opinion AC

## EU Arbitration Convention

### Article 14:

Double taxation of profits is eliminated if:

- the profits are included in computation of taxable profits of one State only, or
- the tax chargeable on these profits in one State is reduced by an amount equal to the tax chargeable on them in the other

## EU Arbitration Convention

Cases?

### Electrolux (France - Italy)

- manufacturing company - sales company
- selection of arbitration panel took 18 months!
- lack of coordination: suggestion of having permanent secretariat for EU arbitration
- similar issues in Belgium, Germany and Spain; calls for multilateral arbitration

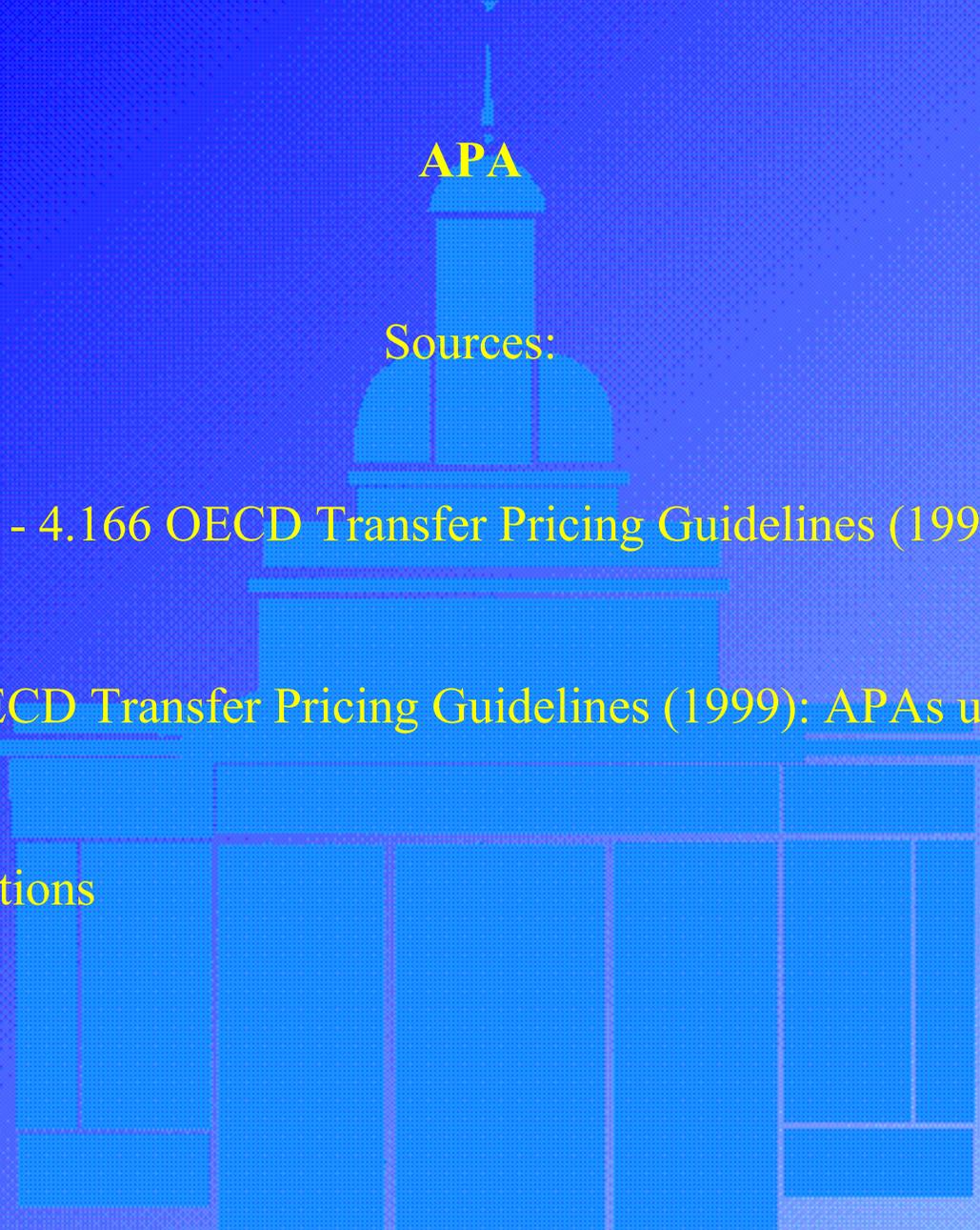
## EU Arbitration Convention

Code of Conduct for effective implementation of Arbitration Convention adopted 7 December 2004, published 31 March 2005 (prepared by EU Joint Transfer Pricing Forum)

- recommendation on documentation, time limits, practical functioning, exchange of position papers in MAP phase
- recommendation on composition, establishment and functioning of Advisory Commission plus requirements of the opinions
- recommendation to suspend tax collection
- accession of new EU Member States to Arbitration Convention within two years after accession to EU

## C. APA General

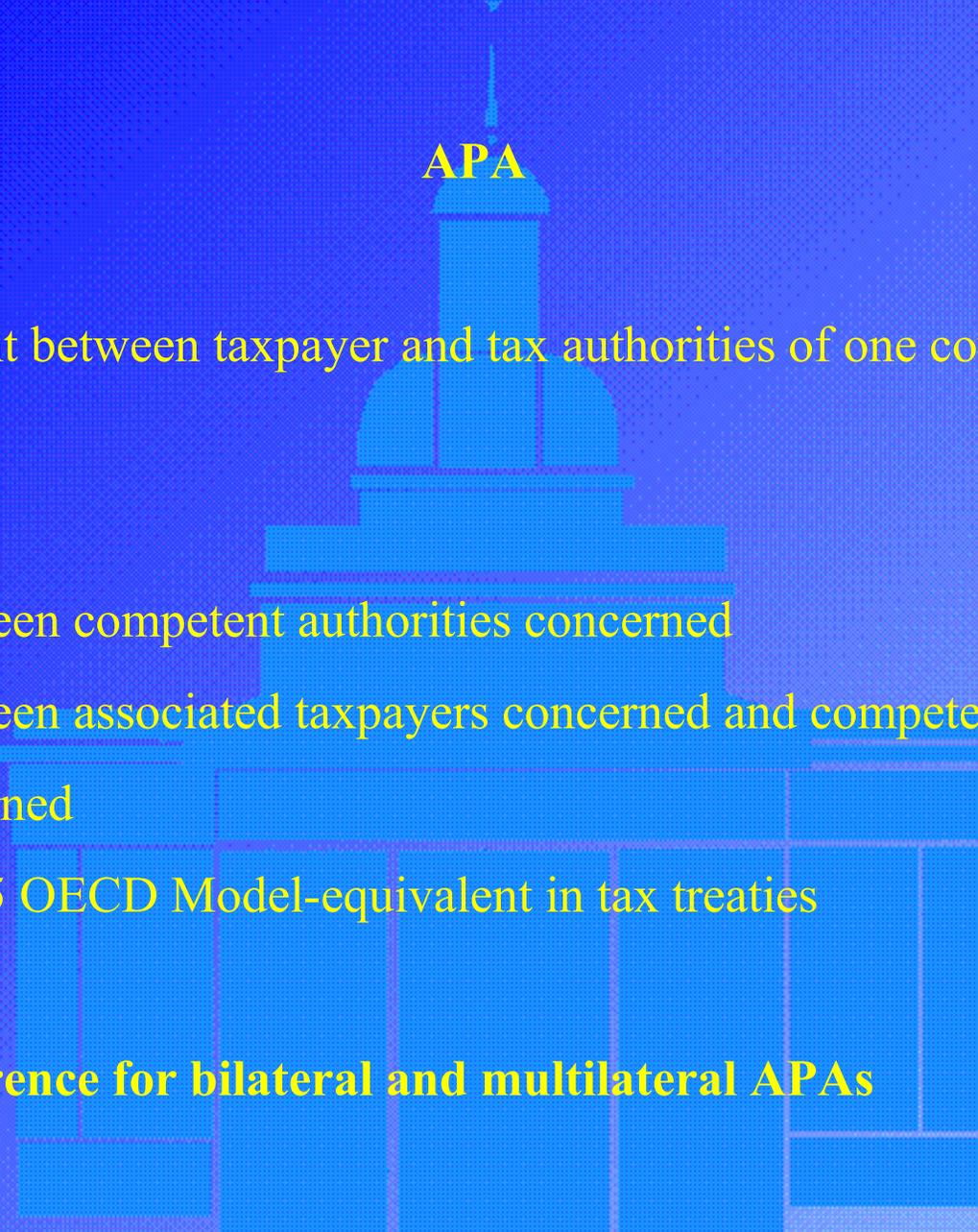
OECD definition: “an arrangement that determines in advance of controlled transactions, an appropriate set of criteria (e.g. method; comparables and appropriate adjustments thereto; critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.



## APA

### Sources:

- Paragraph 4.124 - 4.166 OECD Transfer Pricing Guidelines (1995)
- Annex to the OECD Transfer Pricing Guidelines (1999): APAs under MAP
- Domestic regulations



## APA

Unilateral: agreement between taxpayer and tax authorities of one country

Bi + multilateral:

- 1) agreement between competent authorities concerned
  - 2) agreement between associated taxpayers concerned and competent authorities of countries concerned
- basis: Article 25 OECD Model-equivalent in tax treaties

**Note: OECD preference for bilateral and multilateral APAs**

## APA

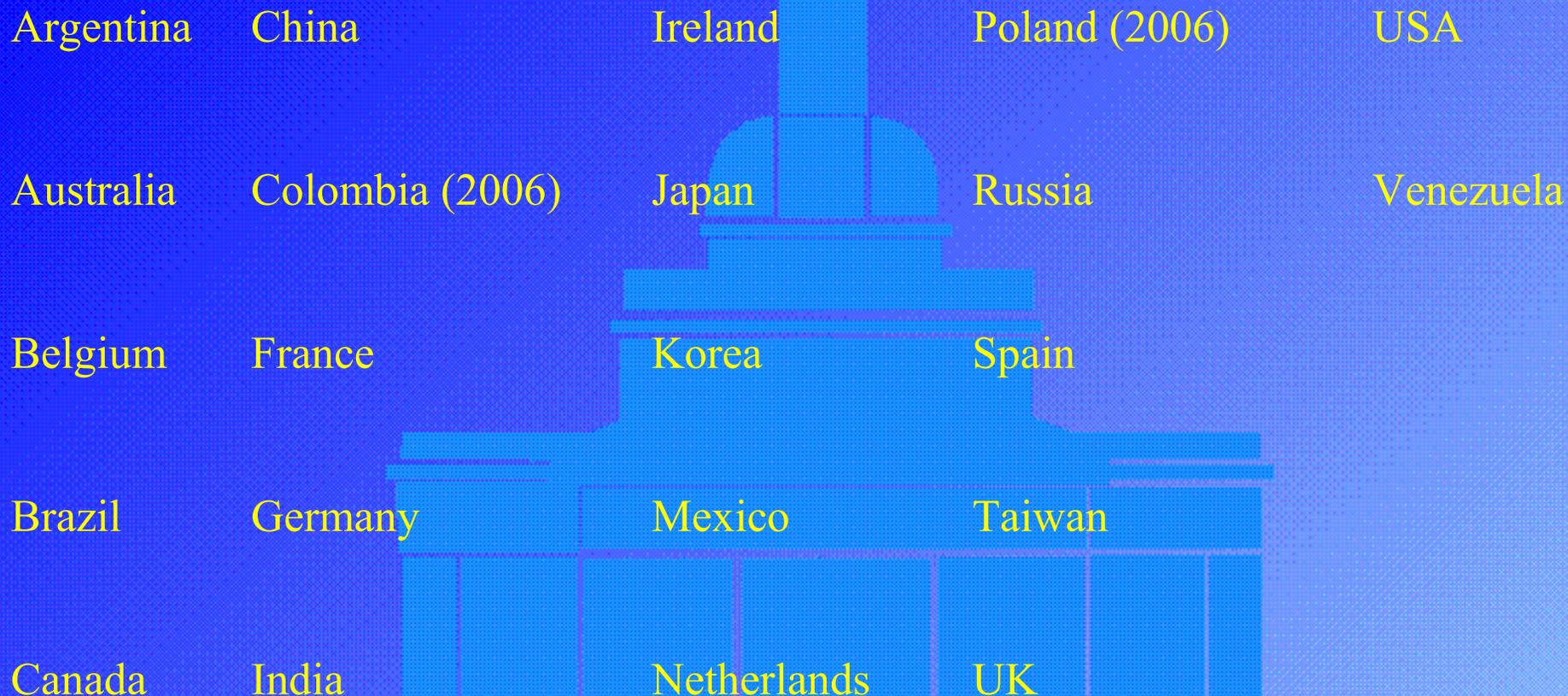
### May cover:

- future specific transaction(s) or groups of transactions, or all transfer pricing issue of taxpayer(s) concerned
- appropriate margins
- TP methods to be applied
- other related issues e.g. income allocation to PEs

Note: in certain countries roll back effect of APA possible:  
APA resolves open issues of past years as well

# APA

Where possible?



Note: several other countries are prepared to conclude APAs applying the MAP under their tax treaties, e.g. Sweden

## China

### China-Japan: first bilateral APA

- May 2005
- based on new APA rules 20 September 2004
- Nine months only to complete!
- China: on one hand emphasis on transfer pricing enforcement; on the other willing to negotiate bilateral APAs (so far 130 unilateral “rulings”)

## Multilateral APA

### Examples

- Two European Financial Services Groups in March 2004, involving Belgium, France, Netherlands
    - time frame: 18 months
    - method: profit split
- (normally Dutch financial industry APAs only cover annual “spread”)

## Multilateral APA

### Examples

- Airbus Industries, April 2004, involving France, Germany, Spain and the UK
  - multilateral meetings
  - per country project teams
  - same information and same presentation to all parties
  - taxpayer not involved in actual multilateral negotiations
  - duration: three years because of Spanish regulation

## German-Pakistani Mutual Agreement on Pharmaceutical Industry

- published bilateral “APA”
- how to treat cases in specific industry
- standard case:
  - parent is responsible for R&D and production
  - subsidiary is secondary manufacturer and distributor
- resale method applied
- also: competent authority of parent may certify that prices charged by parent are internal CUPs

## 2. DOCUMENTATION

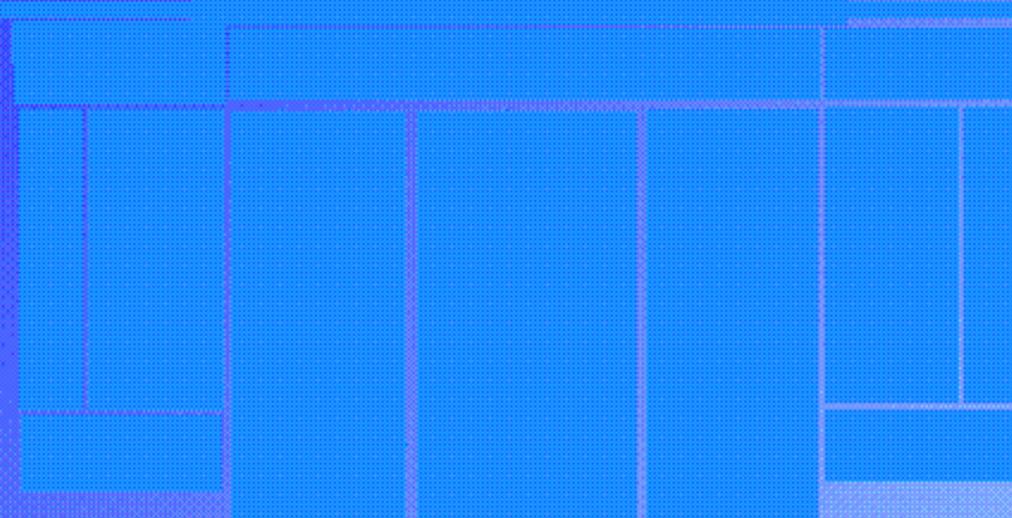
EU

### Joint Transfer Pricing Forum

- Founded in 2002 by the EU Commission
- Mandate prolonged to 2006
- Members: representatives of the MOF of 25 EU member states plus 10 industry representatives
- Task: alleviate the compliance burden for companies in Europe stemming from different TP and documentation rules
- Topics: -- documentation requirements  
-- improvements of MAP/Arbitration Convention

## EU Documentation

- After 15 months' discussion JTPF adopted **masterfile concept** as the EU Transfer Pricing Documentation (TPD) standard on 21 June 2005
- TPD is combination of standardized information covering all EU group members, plus standardized specific information per EU country (if required/requested under domestic rules)





EU

## Content of TPD masterfile:

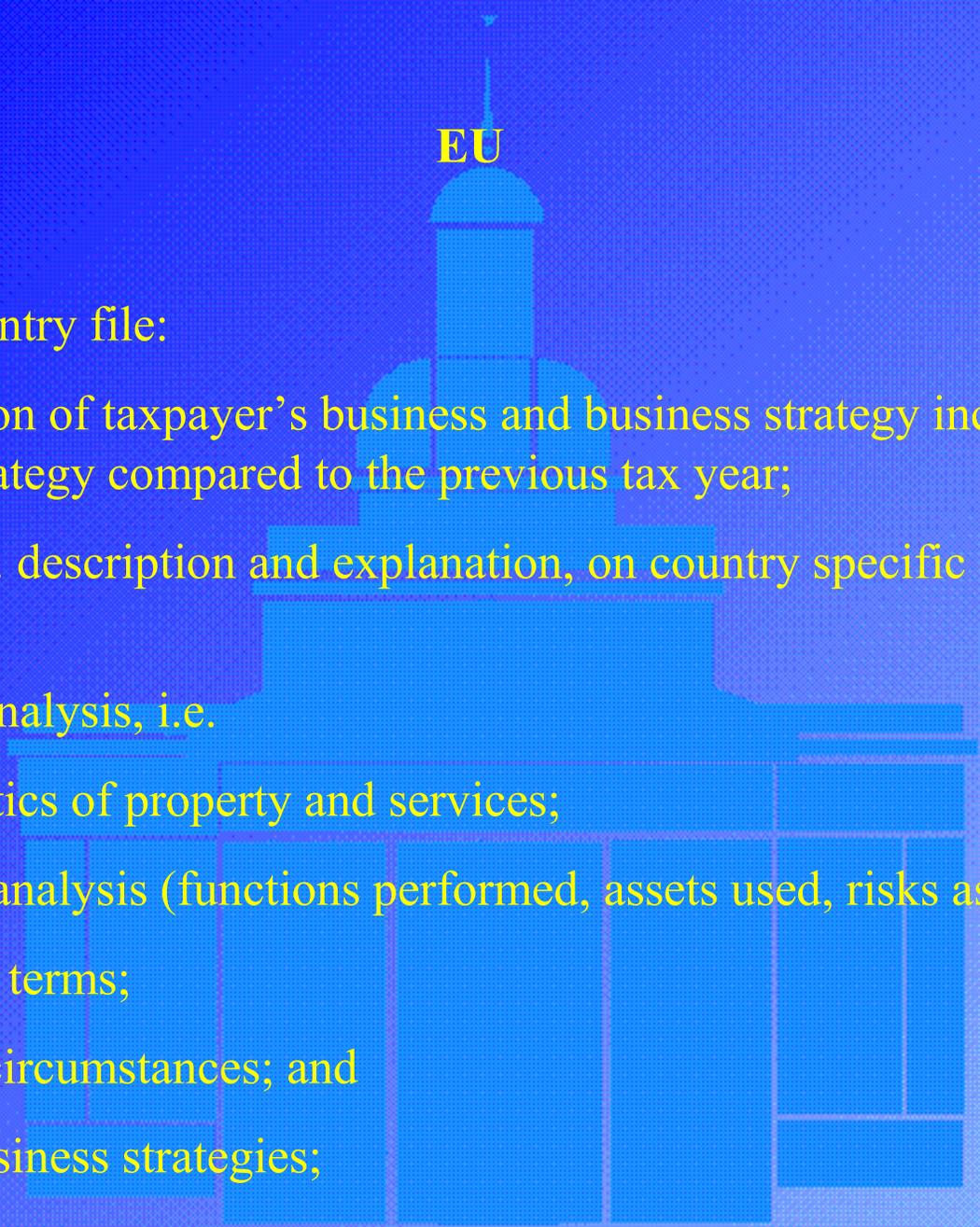
- a) general description of business and strategy including changes in business strategy compared to previous tax year;
- b) general description of the group's organizational, legal and operational structure (including organization chart, list of group members and description of participations of parent company)
- c) general identification of associated enterprises engaged in controlled transactions involving enterprises in the EU;
- d) general description of flows of controlled transactions involving enterprises in EU (invoice and amount flows)



EU

### Content of TPD masterfile (continued):

- e) general description of functions performed and risks assumed and description of changes in respect of functions and risks compared to previous tax year, e.g. change from full fledged distributor to commissionaire;
- f) ownership of intangibles (patents, trademarks, brand names, know how etc.) and royalties paid or received;
- g) the group's inter-company transfer pricing policy or a description of group's transfer pricing system that explains arm's length nature
- h) list of Cost Contribution Agreements, APAs and transfer pricing rulings as far as group members in the EU are affected; and
- i) an undertaking by taxpayer to provide supplementary information upon request and within a reasonable time frame according to national rules.

The background of the slide features a large, stylized silhouette of a classical building with a central dome and a spire topped with a star. The letters 'EU' are printed in a bold, yellow font across the top of the building's dome. The entire background is a dark blue color with a fine, repeating dot pattern.

EU

## Content of TPD country file:

- a) detailed description of taxpayer's business and business strategy including changes in the business strategy compared to the previous tax year;
- b) information, i.e. description and explanation, on country specific controlled transactions;
- c) comparability analysis, i.e.
  - i. characteristics of property and services;
  - ii. functional analysis (functions performed, assets used, risks assumed);
  - iii. contractual terms;
  - iv. economic circumstances; and
  - v. specific business strategies;

EU

Content of TPD country file (continued):

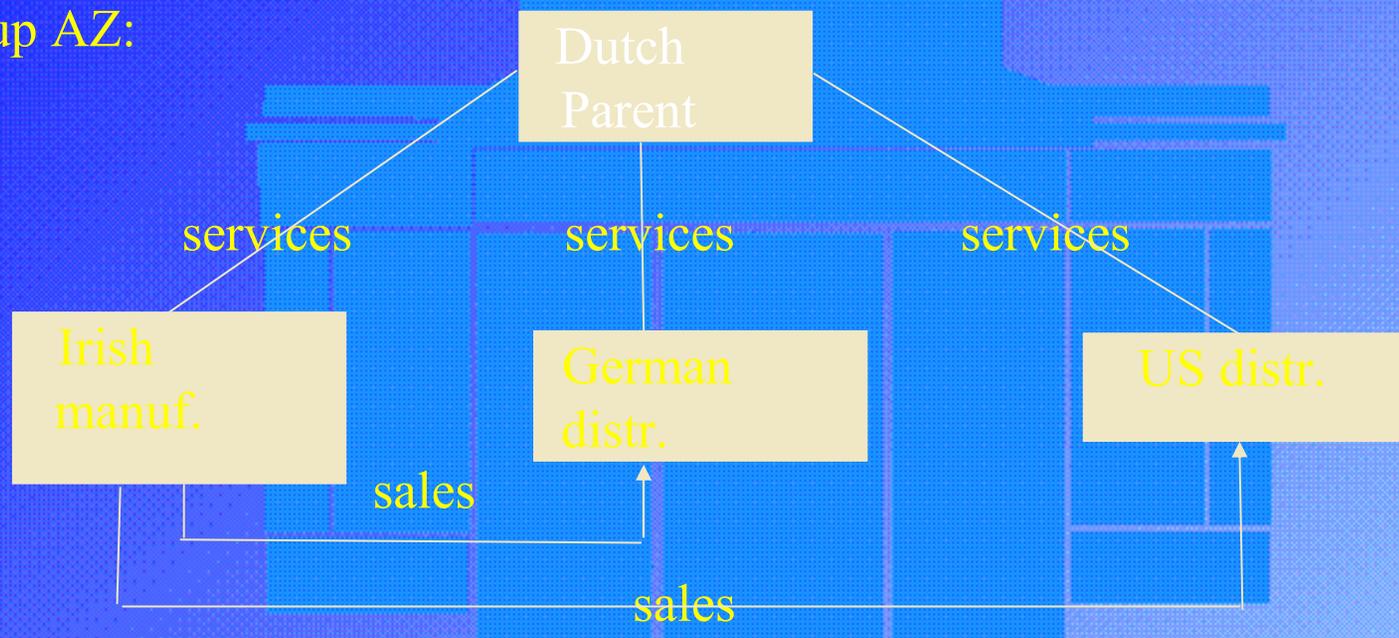
- d) explanation of selection and application of transfer pricing method(s);
- e) relevant information on internal and/or external comparables, if available, and
- f) description of implementation and application of group's inter-company transfer pricing policy.

EU

Consequences of application of TPD

- Information on flows of transactions of MNE within EU and with third countries available to tax authorities of all Member States with one (or more) affiliate(s)

- Group AZ:



EU

Consequences of application of TPD

- Protection against documentation-related penalties
- Optional system, but once adopted no option anymore
- TPD to be made available upon request within reasonable time depending on complexity
- Tax authorities may ask more information upon audit

## EU

### Consequences of application of TPD

- Language of masterfile: English, French or German? (“commonly understood language”); domestic files according to domestic law
- To be applied to all EU group members  
(exception of separate division is possible)
- Recommendation to include TPD in legislation or administrative guidelines of EU Member States (“soft law”; no EU Directive)

### 3. Transfer Pricing and Permanent Establishments

#### Origin Arm's Length Principle:

#### L.o.N. Draft Convention 1933

- Article 3 on PE:

“at the value which would prevail between independent persons dealing at arm's length”

- Art. 5 on Associated Enterprises:

“conditions different from those which would have been made by independent enterprises”

## TP and PE

### Article 7 par. 2 OECD Model

“shall ( ) be attributed to that PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE”

### Article 9 par. 1 OECD Model

“conditions ( ) which differ from those which would be made between independent enterprises”

## TP and PE

Fiction of separate enterprise limited in Commentary to Article 7:

- § 12.1.: internal agreements cannot qualify as legally binding contracts
- § 15: time of realization of profit in case of transfer of goods and equipment
- § 17.4.: payment of royalties or cost sharing arrangement cannot be applied
- § 17.7.: no mark-up on services except in case of main activity
- § 18: payment of interest is incompatible with the true legal nature of a PE

## OECD 2001 Discussion Draft

- Purpose: to examine whether the 1995 OECD TP Guidelines can be applied by analogy to “dealings” between different parts of same enterprise
- Via testing a “working Hypothesis” (WH): determination of functions performed, assets used and risks assumed by PE as if it were a separate and independent enterprise

## OECD Discussion Draft August 2004

Two interpretations of Art. 7(1) “only so much ( ) as is attributable to PE”:

- “Relevant business activity” (RBA) approach: attributed profits cannot exceed profit of whole enterprise from relevant business activity; no profit attributable to PE until (unless) realized by enterprise as a whole
- “Functionally separate entity” (FSE) approach: Art. 7(1) only precludes force of attraction; fiction of distinct and separate enterprise may result in profit for PE and no (not yet a ) profit for enterprise

## OECD Draft August 2004

- Preference among Member States for FSE approach because of being simpler, more administrable and more consistent with ALP
- More explicit support for FSE needed in Commentary to Art. 7
- FSE adopted by WP6 as “Authorized OECD Approach” (“AOA”)

## OECD Draft August 2004

### Symmetrical application of AOA

Application of AOA in home and host country cannot achieve full symmetry:

- different rules on computation of taxable profit
- conflicts of qualification
- different application of rules for avoidance of double taxation
- AOA allows more than one approach to capital attribution
- tax authorities may disagree on application of ALP in particular case

MAP to be used in case of significant divergences

OECD Draft August 2004

Allocation of profit to PE

First step: functional analysis

(1) functions

(2) assets

(3) risks

(4) capital attribution to and funding of the PE

-- measuring the risks and valuing assets

-- determining “free capital”

-- adjust interest expense

## OECD Draft August 2004

Second step: determining PE profits based upon comparability analysis

(1) recognition of dealings”

(2) TP methods

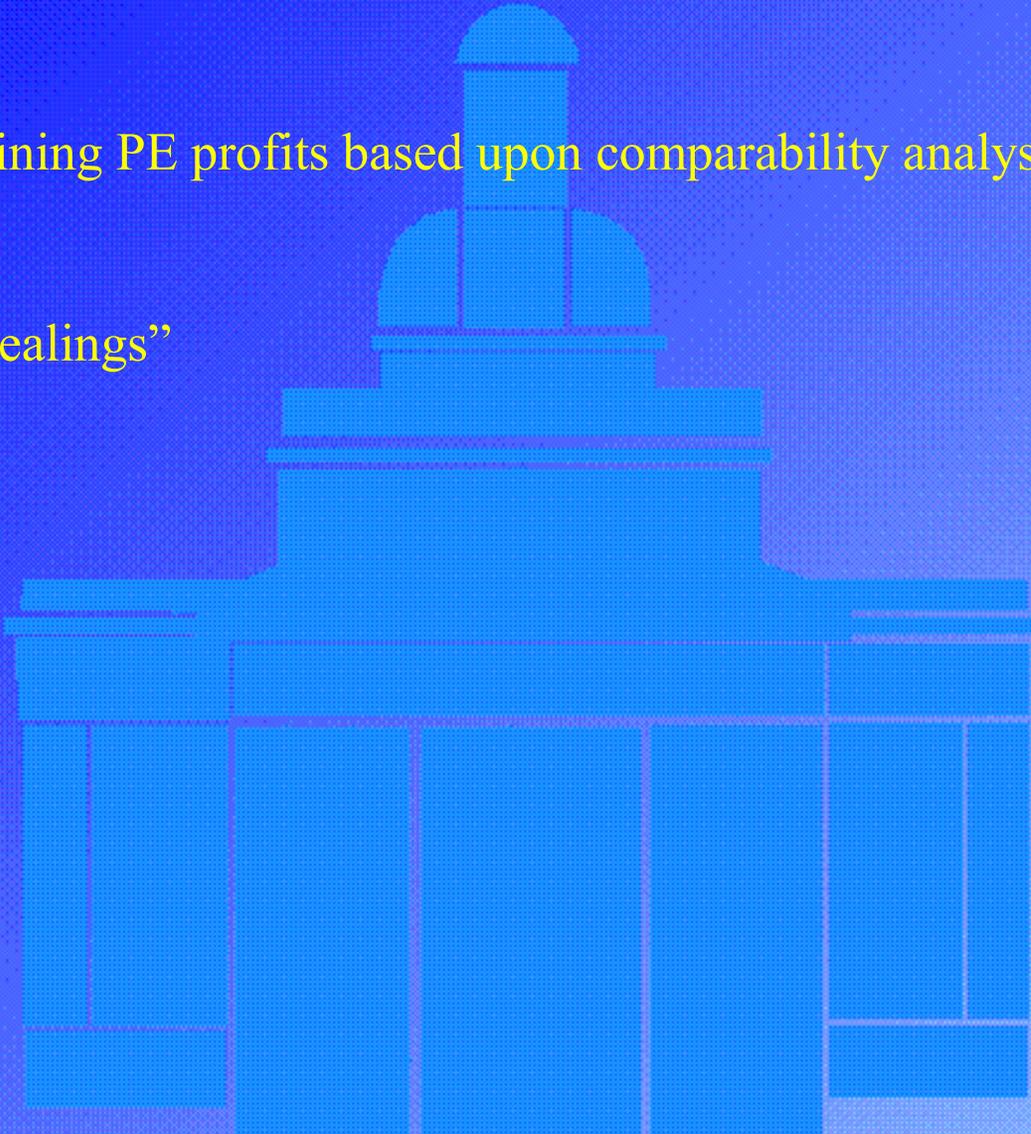
(3) Comparability

-- assets

-- intangibles

-- services

(4) Documentation



OECD Draft August 2004

Functional analysis

- Determine key entrepreneurial risk-taking (KERT) functions of whole enterprise
- KERT: active decision making with regard to most important profit generators
- to which extent does PE undertake one or more of these functions?
- in addition: “reward other functions in accordance with ALP”
- “people functions”

OECD Draft August 2004  
Functional analysis - Assets

- Which capital assets are used by PE (economic ownership)
- Economic ownership connected with KERT
- Acquisition of KERT asset is less relevant than actual use
- Intangible assets:
  - developed by enterprise: economic owner is KERT related to creation
  - acquired from third party: user is economic owner

OECD Draft August 2004

Functional analysis - Risks

- PE assumes any risks inherent in, or created by, the PE's own functions
- As well as any risks that relate directly to PE's activities
- Inventory risk: where is KERT function?
- Credit + collection risk: where is KERT function?
- No further specific guidance on e.g. market risk, product liability risk, warranty risk

## OECD Draft August 2004

### Capital attribution

- AOA: PE must have appropriate amount of capital to support its functions, assets and risks
- Capital follows risk
- How to determine “free capital”? (no interest deduction for free capital)

## OECD Draft August 2004

### Capital attribution

- Four approaches (no consensus on preferred approach)
  - capital allocation approach on basis of assets and risks of PE in proportion to assets and risks of enterprise
  - economic capital allocation approach based on economic risk borne
  - thin cap approach: PE has same amount of free capital as an independent enterprise with similar activities under similar conditions in host country of PE
  - regulatory minimum capital approach: at least same amount of free capital as independent enterprise under host country regulations

OECD Draft August 2004

Adjusting interest expense

- Apply one authorized approach of capital attribution
- Amount of free capital allotted by enterprise is less than outcome of authorized approach
- Then: reduce the amount of interest expense claimed accordingly

OECD Draft August 2004

Methods/Comparability analysis

- Apply TP Methods of Guidelines “by analogy”
- CCA by analogy
- In absence of legally binding contracts: accounting records and specific documentation on internal transfer of PE and enterprise

OECD Draft August 2004

Intangibles

- Determine economic ownership of intangible (KERT)
- AOA allows cost allocation and
- Notional royalty payments

## OECD Draft August 2004

### Services

- AOA recognizes in principle payments for services between PE and other parts of enterprise referring to Guidelines

## OECD Draft August 2004

### Documentation

- Compliance obligation: to create internal contemporaneous documentation on “dealings” between PE and other parts of the enterprise (in analogy of contracts between group companies and with third parties)
- Must reflect actual conduct of PE and rest of enterprise

## OECD Draft August 2004

### Dependent Agent PE

- Article 5 threshold
- Same profit attribution rules as fixed place PE
- Two entities in host country:
  - dependent agent enterprise (resident)
  - dependent agent PE (non-resident)
- If no KERT function, no attribution of assets, risks and profits to dependent agent PE: e.g. mere sales agent >>> arm's length reward
- “Single taxpayer” approach: payment of arm's length reward to dependent agent enterprise extinguishes profits attributable to dependent agent PE
- AOA does not favour “single taxpayer” approach

## OECD Draft August 2004

### Conclusions + Proposals

- Internal documents accepted in absence of contracts
- Deduction of interest and royalties in principle allowed
- CCA in principle accepted
- Realization of profit on internal transfer in principle as with third party
- Services in principle treated in analogy to OECD Guidelines
- Article 7(3), expenses incurred for the purpose of PE: original intent is only to ensure that expenses of a PE's activity are deductible against PE's attributed profits
- No continuing need for Art. 7 par. (4)
- Delete Art. 7 par. (5): "mere purchase ....": conflict with ALP
- Suggestion to amend Commentary Art. 7 and supplement OECD TP Guidelines

## OECD Draft August 2004

### Problems

- Very complicated story; many loose ends
- Consistent and fair application difficult
- Lack of symmetry among jurisdictions in defining profits remains
- KERT differs from OECD Guidelines
- Little guidance on applying KERT in particular
- Attribution of risks very difficult in practice
- No consensus on capital attribution
- Conclusion HH: calls for reconsideration of formula apportionment for PEs

## 4. Other developments

### **Australia**

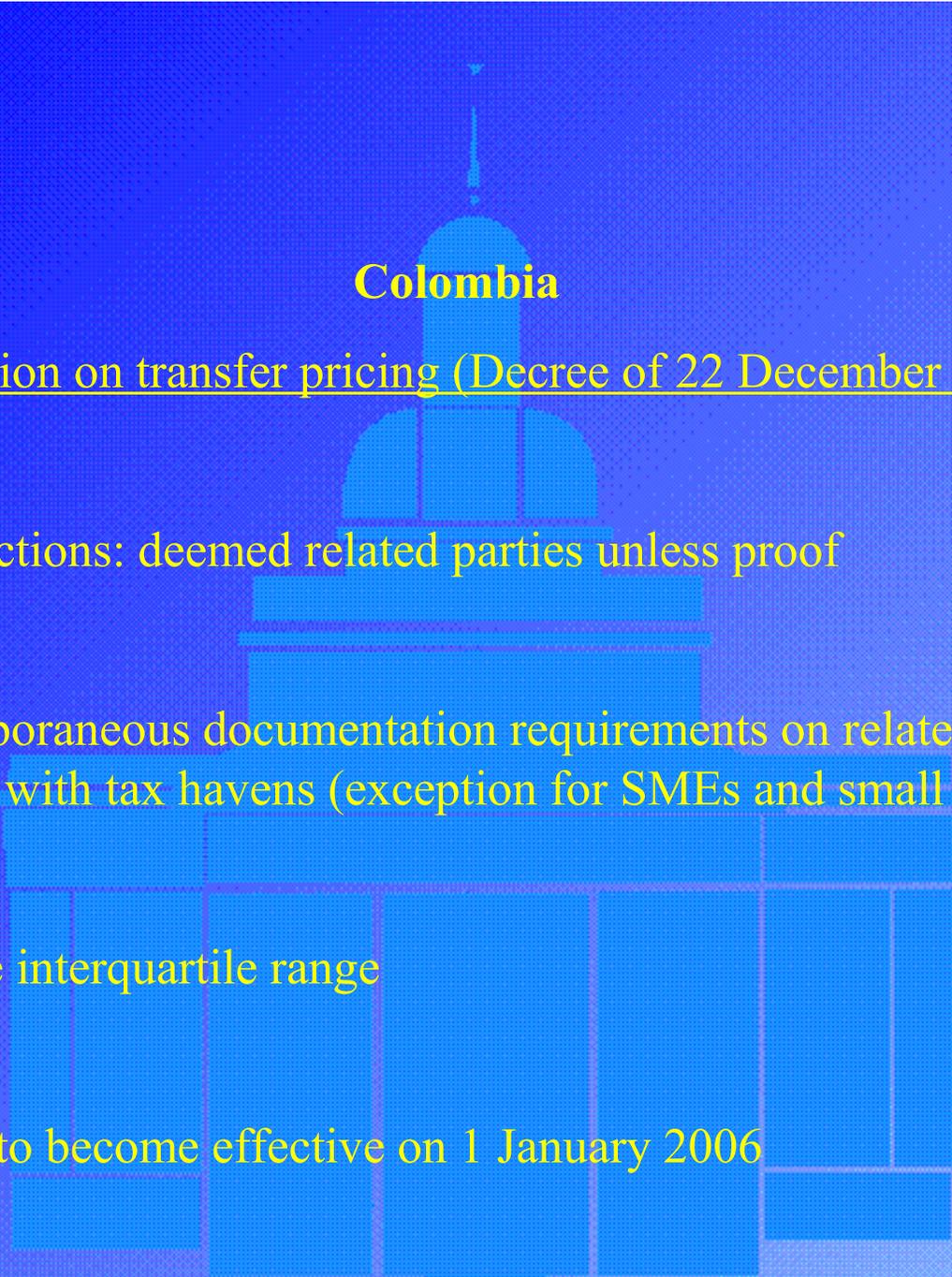
ATO Guide on Attribution of Profits to Agency PE 6 October 2005

- follows approach of OECD 2004 Discussion Draft
- first step: functional analysis attributing functions, assets and risks (FAR) to PE
- second step: comparability analysis on basis of 1995 OECD Guidelines to determine arm's length return
- no zero profit approach: it is arm's length profit for the FAR of the non-resident enterprise in respect of agency activity performed

## China

### Amended Transfer Pricing Regulations, 22 October 2004

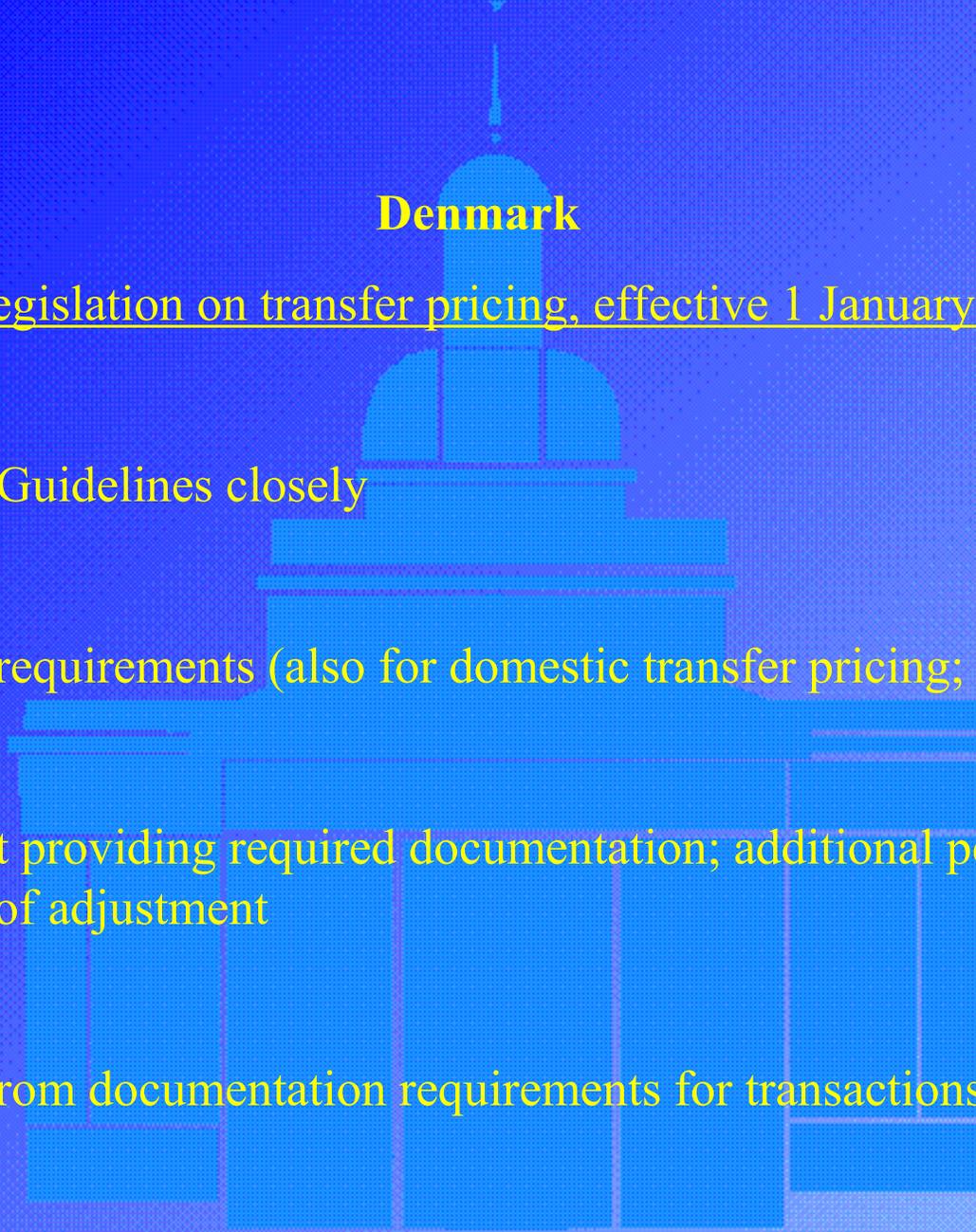
- associated enterprises: broad coverage, including various forms of “control”, e.g. “one enterprise relies on another for production or sale of its products”
- transactions between associated enterprises must be categorized and analyzed in form “Identification of Relationships of Associated Enterprises (to be submitted within four months after tax year)
- selection of cases for audit within two months after receipt of form
- “adjustment methods for tax authorities”: CUP, resale price, cost plus, other methods)
- rules on appeal + litigation
- APA procedure (20 September 2004)



## Colombia

### Regulation on transfer pricing (Decree of 22 December 2004)

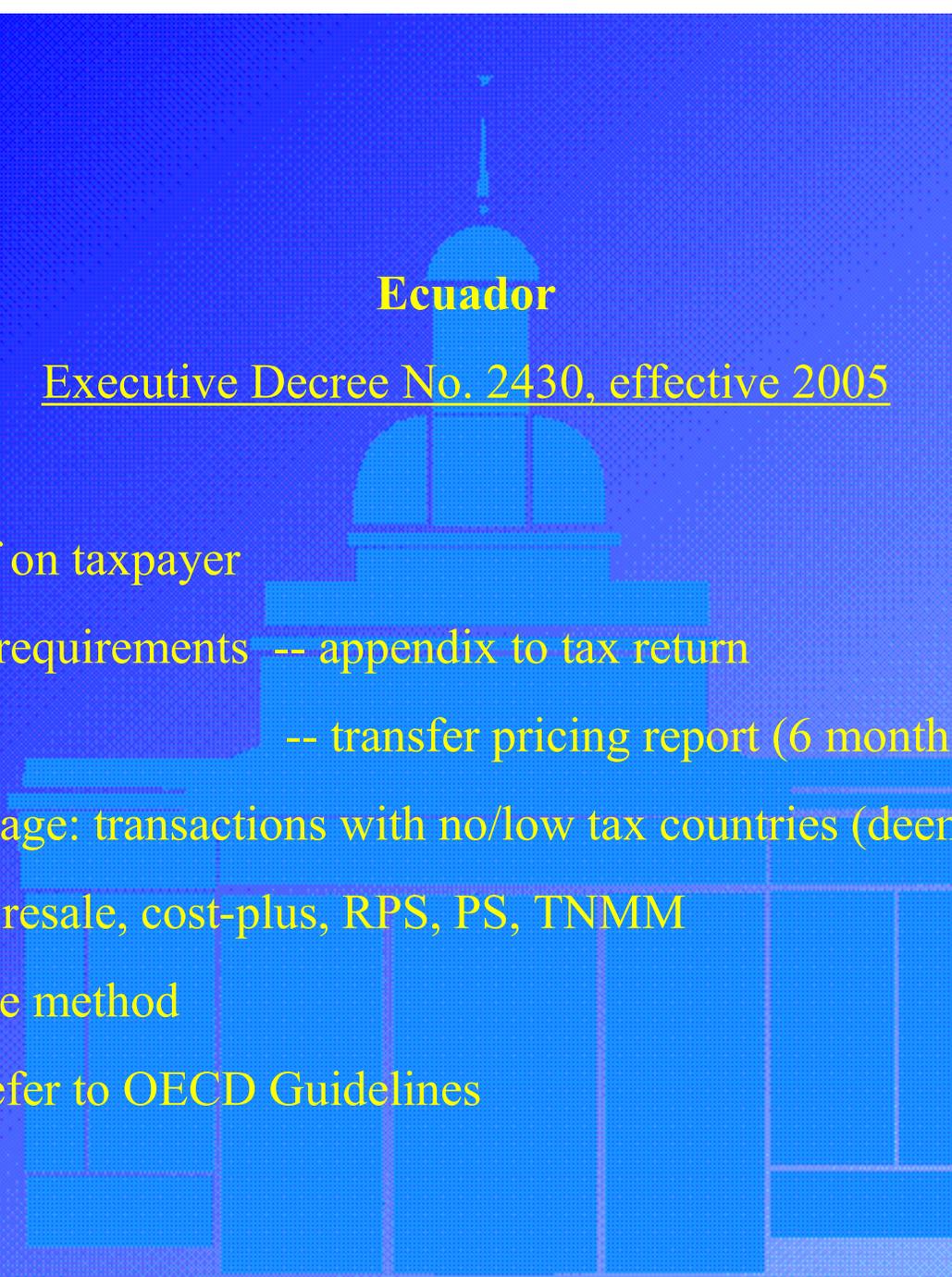
- tax haven transactions: deemed related parties unless proof
- detailed contemporaneous documentation requirements on related party transaction and transactions with tax havens (exception for SMEs and small transactions)
- how to apply the interquartile range
- APA procedure to become effective on 1 January 2006



## Denmark

### New legislation on transfer pricing, effective 1 January 2005

- follows OECD Guidelines closely
- documentation requirements (also for domestic transfer pricing; ECJ!)
- penalties for not providing required documentation; additional penalty of 10 percent in case of adjustment
- SMEs exempt from documentation requirements for transactions within EU or with treaty partner



## Ecuador

### Executive Decree No. 2430, effective 2005

- burden of proof on taxpayer
- documentation requirements -- appendix to tax return  
-- transfer pricing report (6 months later)
- expanded coverage: transactions with no/low tax countries (deemed related parties)
- methods: CUP, resale, cost-plus, RPS, PS, TNMM
- most appropriate method
- taxpayer may refer to OECD Guidelines

## Germany

### Principles for transfer pricing audits, MAP and Arbitration Convention procedure, 12 April 2005

- based on Art. 90(2) and (3) General Tax Code (in force 2003)
- extended duty of taxpayer to cooperate in cross-border situations (sec. 90(2) General Tax Code):
  - keep information abroad
  - keep documentation for 10 years, also on foreign affiliates
  - no obligation to prove that transfer price is at arm's length
- administrative principles of 1983 remain valid for issues not covered by the new audit principles
- binding on tax authorities; indication to taxpayers of documentation tax authorities may require
- apply also to domestic enterprise with foreign PE and vice versa
- guidelines recognize that the correct arm's length price does normally not exist!

## Germany

- secret comparables may be used in audit phase: special rules when used in court
- taxpayer must ensure that he has access to documentation of related parties which is relevant to German tax purposes
- reference to prudent business management for selecting transfer pricing method
- TNMM and profit split may be used as last resort methods under certain conditions (TNMM: for routine functions only)
- CPM does not lead to arm's length results

## Germany

- detailed list of general and specific information, including explanation of value chain
- “serious endeavour”
- submission on request (within 60 days)
- burden of proof rests with tax authorities; if taxpayer violates legal obligation to prepare documentation: presumption of non arm’s length pricing
- obligation for tax auditors to discover also facts that are beneficial to taxpayer!
- procedural instructions + tax audit report requirements for MAP and EU

## Korea

### Guidelines for assessing taxes on cross border transactions (15 June 2004)

- 20 percent penalty for underreporting (from tax year 2003)
- management fees paid by Korean Sub to foreign Parent only deductible if provided on same terms to independent party
- transactions correcting not-at-arm's-length transfer prices recognized if made in same tax year

### New policy on transfer pricing audits (10 June 2004)

- all tax assessments on transfer pricing by local tax offices must be checked by NTS head office before finalization in order to avoid unreasonable assessment and to enhance consistency



## Russia

### Proposed amendments to transfer pricing provisions in Tax Code (December 2004)

- broader definition of related parties
- coverage extended to intangibles
- 20 percent deviation safe haven replaced by arm's length range
- CPM and profit split added as last resort methods
- documentation to justify "market price" now required



## Taiwan

### Detailed transfer pricing regulations, issued 28 December 2004

- transfer pricing methods including CPM and profit split
- best method rule
- documentation requirements upon filing tax return (exemption for SMEs)
- APA programme
- penalties

USA

Regulatory developments

- Proposed Service Regulations
- Proposed Cost Sharing Regulations



## Worldwide trends

- after period of tightening TP rules and administration now more emphasis on taxpayer's position:
  - APA introduced in many countries
  - improvements of MAP
  - arbitration in EU and tax treaties
- definition of “associated enterprises” broadening
- special documentation requirements for transfer pricing
- need of standardization of documentation requirements recognized
- SMEs (partly) exempt from documentation requirements
- OECD: attempt to remove exceptions to ALP in case of PE
- OECD: priority for traditional methods over profit-based methods is disappearing

Name document:

HH-courses

Recent developments TP Mumbai, Dec. 2 2005.ppt

