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Welcome to the first 2008 edition of *Tax Planning International* *Transfer Pricing*.

I am pleased to be able to open our new volume with an article from
Karl Wündisch discussing the Fiscalis seminar in Hungary "How to
conduct a transfer pricing audit", held in November. Transfer pricing
has been on the Fiscalis agenda from the beginning and is developing
in importance with the growth of the European Union, with this year's
seminar addressed by member states' tax inspectors. Herr Wündisch
concludes that in the EU, as elsewhere, transfer pricing should not be
allowed to evolve into yet another competitive disadvantage.

Next, Jane Backhouse and Damian Preshaw report on an important
case in Australia, where the High Court recently granted a taxpayer
special leave to appeal a decision of the Full Federal Court which had
denied the taxpayer's request that the Commissioner of Taxation
should disclose particulars concerning determinations made against
the taxpayer with respect to cross-border related-party transactions.
The authors recommend that, whatever the outcome of this case,
taxpayers must support the arm's length nature of such transactions
with analysis and documentation.

We then move on to our annual 'school report' where correspondents
in various jurisdictions detail what has happened in their transfer pricing
landscape over the last year, and make some predictions for the
coming year. First is Colin Clavey, outlining what is happening at the
OECD, followed by Alexander Voegelé, Wolf Witt and Jean-Benoît
Voegelé's examination of the situation in Germany. For the report from
Latin America I am extremely grateful to Moisés Curiel, who has
documented Mexico himself and pulled together authors from
throughout the continent to cover other jurisdictions. Clive Jie-A-Joen
and Jeroen Geevers bring our report from the Netherlands, while the
United Kingdom is covered Danny Beeton, Guy Kersch and Torquil
Carlisle. Finally, I am grateful to Betty Fernandez for arranging our
article from the United States.

Do keep in mind that the *Special Additions* sections of the *Tax Planning
International Transfer Pricing* homepage contains additional articles and
reports for which we don't have space in the printed journal – if you
need a reminder of your login and password, just email
customerservice@bnai.com

Happy New Year!

Lillian Adams

EU: grooming future leaders in transfer pricing

Karl Wündisch

Observations from the Fiscalis¹ seminar in Hungary on November 20-21, 2007, “Transfer Pricing: How to conduct a transfer pricing audit”, suggest more resources be allocated to Member States’ officials understanding, increasing their potential to lead in transfer pricing within and outside the European Union.

The European Union’s initiative to take an active role in the development of transfer pricing with the commissioning of the “EU Joint Transfer Pricing Forum” (EUJTPF) in 2002 is now in its sixth year. Altogether 19 meetings are recorded of authorities from initially 15 and now 27 EU Member States and with observer status, of representatives from the OECD and the EU Commission. These joint public and private sector deliberations were aided initially by 10 and now 15 professionals with insights from industries and business consultancies.

Due to the recent enlargement of the European Union (in 2004 and 2007) from 15 to 27 Member States this important project² will require the application of proven project management skills to gain progress and to find agreement within such a large group of professionals (and their respective governments) and to succeed with its ambitious agenda.

With Fiscalis the European Union established, almost concurrent to the EUJTPF, a multi-annual Community action programme, initially for the period from January 1, 2003 to December 31, 2007, to reinforce the functioning of the indirect taxation systems of the EU internal market.

“The objectives of this programme are:

to achieve among officials a high common standard of understanding of Community law, particularly in the indirect tax sphere, and of its implementation in the Member States;

to secure efficient, effective and extensive cooperation among the Member States and between them and the Commission;

to ensure the continuing improvement of administrative procedures so as to take account of the needs of administrations and taxpayers through the development and dissemination of administrative best practice.”³

To ensure these objectives to become reality professional training programmes – similar to the OECD outreach programmes – for delegated officials of all Member States including language skills were organised. An indeed formidable but necessary task should the overall goal of the EU common market’s competitiveness eventually be achieved.

Transfer pricing was on the agenda of the Fiscalis programme from the beginning and has gained in emphasis over the last years.⁴ This year’s seminar was addressed at the EU Member

States’ tax inspectors. Within the group of more than 50 delegates they were to develop a better understanding of how and under what circumstances to conduct a transfer pricing audit. They were to consider the needs for prioritising their own resource utilisation and to recognise the significant resources devoted by multinational enterprises for safeguarding against any undue transfer pricing risk exposure. Transfer pricing practitioners from Baker & McKenzie⁵ and the author were invited to share private sector experiences with the officials. They presented how multinational corporations develop their documentation assisted by specialised transfer pricing consultancies and the corporations’ best practice of preparing for transfer pricing audits. A welcome support for these efforts is noted in the commitments from the OECD⁶ and competent authorities from the U.K. and Belgium.⁷

Edward Morris,⁸ chairing the Fiscalis seminar, stressed in his opening remarks the complexity of transfer pricing and particularly the unprecedented burden on governments and corporations alike. The ever increasing cost of compliance and the aim of corporations to mitigate the risk exposure resulting from transfer pricing unduly eats into the profits which both governments and corporations are aiming at to have their share of.

Conference language

As it is common practice in proceedings organised by the European Commission, the Fiscalis seminar also provided for simultaneous interpretation facilities to and from English, French, German and, in this case, Hungarian. With relief it was noted that this actually was necessary only for a few delegates. On this working level the European integration has advanced already to the extent that most of the officials were comfortable with English while following the presentations as well as during the discussions thereafter.

Training approach

Prior to the seminar delegates received electronically submitted presentations and case studies for their individual perusal.

Presentations from the Hungarian, the Belgian and the U.K. competent authorities as well as from the OECD and the private sector representatives offered advice from the most experienced in transfer pricing – from the perspective of the authorities as well as that of multinational enterprises.

Presentations and ensuing discourse

A hopeful sign of *Zeitgeist* became evident in the presentations by Sam Shephard and the author, with both focussing on the issues surrounding risk assessments. The perspectives from the U.K. competent authority and from the business representative congenially matched as both explored and emphasised the benefits of such a business-like approach.

Under a new approach to transfer pricing, being introduced in 2008, U.K. auditors will be required to submit a business case to dedicated transfer pricing specialists before officially taking up a new transfer pricing case and starting an audit. This will include an estimate of the tax at risk and the resource requirements for carrying out an enquiry. A new enquiry will be commenced only with the approval of transfer pricing specialists, who will be involved in the conduct of every transfer pricing enquiry.

HMRC has shown itself to be sensitive to the costs, both to itself and to taxpayers, involved in large and time-consuming transfer pricing audits already since 2002 with Tax Bulletin 60.⁹ Now, with its June 20, 2007 publication¹⁰ “promoting a collaborative debate with our customers” and by using a risk review template, HMRC has presented a commendable business-like approach, the practice of which will be followed attentively.

A caveat has already been raised from the business perspective because of GlaxoSmithKline and HMRC still reporting an imminent litigation on the grounds of double taxation. After 17(!) years of inconclusive negotiations and the eventual settlement with the IRS in late 2006 both the corporate group as well as the U.S. and the U.K. governments have incurred management time and expenditures hitherto unheard of. This must be the loss-loss against the ideal of a win-win situation in transfer pricing and should become the no-no example to deter anyone from repeating such an inordinate consumption of public and private funds.¹¹

Interestingly, there was much reference and query as to the number of parties involved in a transfer pricing audit. The tax inspectors were considering as many as in bilateral competent authority negotiations.

The private sector representative on the other hand made a strong point to enhance the awareness of the authorities as to the immense resources of management time blocked and monies spent over an uncertain time period.¹² Communications and, when it comes to expenditures, negotiations are necessary between corporate functions not only with the management of the group company under (potential) audit but also with the affected related group companies’ management and that of their respective regional and corporate levels.

In addition to internal resources – the corporate functions transfer pricing, accounting, controlling, legal, tax, finance, the board of management and the supervisory board including their legal compliance function and audit committee (as well as their counterparts on the regional and national levels) – resources from external auditing firms and specialised transfer pricing consultants are either part of the project team or to be reported to from time to time. Depending on the complexity of the organisational structure of the multinational enterprise another management layer may need to become involved as well.

Similarly, in nation states with a decentralised structure of governments multinational corporations have seen transfer pricing audits unduly prolonged as a result of an opaque system of supremacy and decision making between their respective local, regional and federal authorities.

All of the reasoning above clearly mandates the corporate transfer pricing function in multinational enterprises to prepare and therewith to safeguard the organisation with the implementation of a Transfer Pricing Risk Management Programme throughout the group of companies.¹³

Case Studies

Seven simplified case studies were intended to uniquely represent the auditors’ scenario with six of them providing the supposedly common situation of rather limited information available to auditors. They were meant to inspire the analytical mind of the tax inspectors to make a decision for or against opening an enquiry and starting an audit.

At the other extreme, the attending fiscal authorities were confronted with a full blown documentation package containing a sample transfer pricing policy and benchmark analysis of a multinational enterprise prepared by Baker & McKenzie.¹⁴ The auditors were asked to consider the transfer pricing study and raise their concerns, if any. Intangibles for marketing efforts and the related level of royalty payments were the focus of analysis. The auditors proposed adjustments prior to realistically postured negotiations with the (mock) taxpayer and its counsel Monique van Herksen and Pierre-Yves Bourtourault. The case study subsequently required the respective tax authorities to engage in competent authority discussions to defend their proposed adjustments and to obtain relief from double taxation for the taxpayer. This proved to be as challenging as the negotiations with the taxpayer in agreeing to an adjustment.

The approach to create a rather realistic and therewith educative exercise resulted in a spontaneous discourse between the auditors who hitherto neither knew the case nor each other, but may be facing each other in real-life negotiations soon. Their exercise clearly demonstrated to everyone the broader (than domestic) mindset needed for adequately solving transfer pricing cases: a global view with the ability to accept the need for considerable flexibility could prove to be the key for productive decision making.

Time frame

Harvard University is known to be the originator of case studies in training business students as well as corporate executives under time pressure – however, not as severe as it was the case at this seminar. It was apparent to everyone that the absorption of complex content, dialogue (for most in a foreign language) about facts and circumstances relevant for decision making requires time, more than there was available. Already from the outset it became clear, therefore, that deliberations had to be limited to only a few cases and therein a few pivotal issues.

The approach setting up mock negotiations between auditors and tax payers was much appreciated, which would have been the case even more so would there have been more opportunity to do so.

Where to go from here?

Budget considerations were given as reason for limiting also this year’s Fiscalis seminar to only two days. Given the complexity of the issues on the agenda, the need for Member States’ officials to become fully in command of the international dimensions of the transfer pricing work, and the skill-building benefit that case studies provide, a full week – as it is the practice in the much valued outreach programmes directed to non-OECD Member States – would be appropriate and prove to be a good investment.

The efforts demonstrated by the public and private contributors and the attending tax officials could prove to generate significant productivity if also the Fiscalis programme could gain support from a new leadership drive in transfer pricing.¹⁵ More resources

specifically devoted to such Public Private Partnerships are needed if this leadership potential is to be realised.

The payback for Member States' tax administrations and multinational enterprises alike will come quickly when the full understanding has sunk in of Europe being foremost in competition with the rest of the world, rather than among its Member States. Here, as elsewhere, transfer pricing should not evolve into another competitive disadvantage. Rather, the same principles should be applied the world over under the guiding umbrella of the OECD.

Karl Wündisch, *Transfer Pricing Consult Pharma-Biotech*, is a former corporate officer of Schering AG, Germany (now part of Bayer Schering Pharma AG) with over 25 years of corporate governance responsibilities for the Schering Group worldwide, having created the corporate departments for transfer pricing, portfolio control and trademarks. His call for a new political leadership drive in transfer pricing was reported in "Rampant Globalisation - Yet a Dearth of Professionals to Lead the Way in Transfer Pricing?", *Tax Planning International Transfer Pricing*, BNA International London, Vol.8, No.8, August 2007.

- 1 For details on FISCALIS see <http://europa.eu/scadplus/leg/en/lvb/l31037.htm>
- 2 The proceedings of the 19 EUJTPF-meetings, key documents and curricula vitae of the newly elected 15 business members can be reviewed at http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm.
Commentary is provided by the media specialising on transfer pricing, see for instance: Van Stappen, Dirk. "EU Commission issues APA guidelines based on the work of the EU Joint Transfer Pricing Forum". *Tax Planning International Transfer Pricing*, Vol.7, No.7, July 2007; Van Stappen, Dirk. "EU. JTPF making progress". *Tax Planning International Transfer Pricing*, Vol.4, No.9, September 2003; Van Stappen, Dirk. "European Union: first meeting of the Joint Transfer Pricing Forum". *Tax Planning International European Union Focus*, Vol.4, No.10, October 2002; Van Stappen, Dirk. "EU Joint Transfer Pricing Forum established", *Tax Planning International Transfer Pricing*, Vol.3, No.9, September 2002.
- 3 See: <http://europa.eu/scadplus/leg/en/lvb/l31037.htm>

- 4 Four seminars on Transfer Pricing issues have been organised within the framework of the Fiscalis Programme: "Transfer Pricing and EU Arbitration Convention" (November 2003), "Organisation Structures and Training Methodologies for Transfer Pricing Audits" (2004), "The use of database searches for comparables" (2005) and "Transfer Pricing and intangibles" (2006).
- 5 Monique van Herksen (Netherlands) and Pierre-Yves Bourtourault (France)
- 6 Colin Clavey, Senior Advisor, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD
- 7 Sam Shephard (HMRC) and Stefaan De Baets (Belgian Tax Administration)
- 8 European Commission, DG-TAXUD, Responsible for EU Joint Transfer Pricing Forum and EU Arbitration Convention; former U.K. competent authority
- 9 See: www.hmrc.gov.uk/bulletins/tb60.htm, "Risk Assessment Process"
- 10 "HMRC Approach to Transfer Pricing for Large Business, Consultation Document", See: www.hmrc.gov.uk/large-business/new-approach.htm
- 11 The author is, of course, aware and on record that all of the intelligence having gone into preparing for the defence of GlaxoSmithKline in the U.S. courts would in all probability have brought a positive decision for the pharmaceutical-biotech industry on the issue of "marketing intangibles". However, not having been resolved in the U.S., it has now by chain reaction evolved into a claim of precedence by many other fiscal authorities not only against U.S. corporations.
- 12 Consider also FIN 48 reporting requirements: Wright, Tamu, "10-Q FIN 48 Disclosures Show Firms Uncertain About How Transfer Pricing Positions Will Be Viewed", BNA's *Tax Management Transfer Pricing Report*, Vol.16, No.10, September 25, 2007.
- 13 Wündisch, Karl "Optimale Organisation des Transfer Pricing als Risk Management Programm", in *Internationale Verrechnungspreise*, Lektion 5, Management Circle Verlag, 2. Auflage, Eschborn 2007
- 14 *BNA Tax Portfolio*, Practical Applications in a Transfer Pricing Study – A Case Study by Marc M. Levy, Phil Carmichael, James Dougherty, Monique van Herksen, all with Baker & McKenzie, New York or Amsterdam.
- 15 As it has been suggested in the author's earlier article referenced in the biographical paragraph.

Australia: High Court considers taxpayer's challenge

Jane Backhouse and Damian Preshaw
KPMG, Melbourne

The High Court of Australia recently granted a taxpayer special leave to appeal a decision of the Full Federal Court of Australia which had denied the taxpayer's request that the Commissioner of Taxation be required to disclose certain particulars concerning transfer pricing determinations made against the taxpayer with respect to cross-border related-party transactions. *WR Carpenter Holdings Pty Ltd v. Commissioner of Taxation* 2007 HCATrans 801 (December 14, 2007).

Background

Under Australia's transfer pricing rules – contained in Division 13 of Part III of the *Income Tax Assessment Act 1936* (Division 13) – a taxpayer will be deemed *not* to have received arm's length consideration in respect of a cross-border related-party dealing when:

- the taxpayer supplies property under an international agreement.
- the parties were not dealing at arm's length with each other.

- the consideration received was less than the arm's length consideration.
- the Commissioner makes a determination that the transfer pricing rules should apply.

Earlier administrative and court actions

In the *WR Carpenter Holdings* case, the Commissioner of Taxation in July 2004 made transfer pricing determinations in respect of certain cross-border related-party dealings of the taxpayer.

During the course of litigation, the taxpayer sought certain particulars concerning the matters which the Commissioner took into account in making these transfer pricing determinations. The Commissioner refused to supply the particulars sought.

Both the Federal Court at first instance and the Full Federal Court of Australia (in a case handed down on July 11, 2007) dismissed the taxpayer's request that the Commissioner be required to supply these particulars.

In dismissing the appeal, the Full Federal Court of Australia relied on a number of cases concerning the Commissioner's discretion under Part IVA of the ITAA 1936 (which generally supports the principle that it is not open to a taxpayer to challenge an assessment under Part IVA by showing some error in the making of the Commissioner's determination).

Observation

The *WR Carpenter Holdings* case is the most recent in a line of cases that examined the issue whether taxpayers may

challenge transfer pricing assessments on administrative law grounds, through judicial review of the exercise of the Commissioner's discretion to apply the transfer pricing rules.

If the High Court of Australia ultimately dismisses the taxpayer's appeal and the decision of the Full Federal Court is allowed to stand, then in order to challenge transfer pricing assessments, taxpayers will need to follow the normal objection and appeal processes set out in Australia's *Taxation Administration Act 1953*.

However, if the High Court of Australia upholds the taxpayer's appeal, then there may be an additional avenue for taxpayers to challenge transfer pricing assessments, by challenging the validity of the transfer pricing determination.

Regardless of the outcome of the appeal in *WR Carpenter Holdings*, observers strongly recommend that taxpayers need to support the arm's length nature of their cross-border related-party transactions by analysing and documenting the fundamental economics of those dealings, following established transfer pricing principles.

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Current OECD initiatives

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Recent years have witnessed an unprecedented growth in international trade between related parties. At the same time, growing numbers of tax administrations have introduced rules to control, for tax purposes, the pricing of these related-party transactions. Both these trends will no doubt continue. Tax administrations, of course, introduce transfer pricing rules to protect their tax bases from erosion arising from internal transfer pricing between members of the same multinational enterprise (MNE). MNEs, on the other hand, are faced with the efforts and costs of complying with transfer pricing rules, and they generally want some certainty about how their intra-group transactions will be treated. Both tax administrations and business are concerned to ensure that transfer pricing rules do not create double taxation, nor create barriers to normal trade or normal business processes. Neither tax administrations nor MNEs want compliance or implementation costs to escalate out of proportion. This is the context in which many of the current OECD initiatives on transfer pricing are taking place.

One of the primary objectives of the OECD's work on transfer pricing is the avoidance of both double taxation and the barriers to international trade and investment that uncertainty of treatment and double taxation potentially create. The roots of economic double taxation potentially lie in countries applying and interpreting transfer pricing rules in different ways. Consensus between countries and consistency of approach are paramount if double taxation is to be avoided. Very nearly every country that has introduced transfer pricing rules has adopted the arm's length principle, and the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Transfer Pricing Guidelines) provide international consensus on the application of that principle. The OECD's continuing work in the area of transfer pricing has the overarching aim of achieving further consensus and consistency of approach between tax administrations – both those that have well established transfer pricing rules and those introducing them for the first time.

The rest of this article describes the current initiatives and projects being carried out by the OECD in the area of transfer pricing. Much of the work falls to Working Party No. 6 (The Taxation of Multinational Enterprises) of the Committee of Fiscal Affairs, but, as will be seen, particular projects are being worked jointly with Working Party No. 1 (OECD Model Tax Convention).

Reviews of comparability and profit methods

The OECD continued during 2007 its two closely linked reviews of existing guidance on comparability and profit methods. These reviews are part of the continuing process of monitoring the Transfer Pricing Guidelines.

The review of comparability recognises a number of issues faced by both taxpayers and tax administrations concerning the identification and analysis of third party comparable information. These issues were summarised in a series of Issues Notes released for public comment in May 2006. ("Comparability: Public Invitation to Comment on Series of Draft Issues Notes"). These notes stress the central importance of a comparability analysis, both for taxpayers in determining how their transfer prices should be established, and for tax administrations in determining whether a transfer pricing adjustment should be made and if so how it should be quantified. Furthermore, the Working Party's review of comparability aims at taking account of the practical experience acquired in this field since the Transfer Pricing Guidelines were drafted in 1995, with the objective of developing a standard that is both theoretically sound and workable in practice. Working Party No. 6's next task is to work on revising Chapter I of the Transfer Pricing Guidelines in the light of comments received.

The review of transactional profit methods is considering the practical application of the transactional net margin and the transactional profit split methods as well as whether they should retain their current status as methods of last resort. Working Party No. 6 is working on a number of Issues Notes which are expected to be released for public comment in early 2008. The outcome of these reviews will be revised guidance on these issues in Chapter III of the Transfer Pricing Guidelines.

Effective dispute resolution

The issue of the resolution of disputes between tax authorities has been a major concern for businesses, especially as the number and complexity of such issues has increased and can be expected to continue to do so in the future. With regards to transfer pricing, the issue arises when, in the application of their treaties to individual cases, countries disagree on how the arm's length principle is to be applied. If a taxpayer in one country is the subject of a transfer pricing adjustment in relation to a transaction with another country, then the related party in that other country may approach its own tax administration for a corresponding adjustment. This would be made under the terms of the relevant double taxation treaty between the two countries and, if accepted, would have the effect of decreasing by a corresponding amount the taxable profit to be recognised in the other country. An issue arises if there is disagreement over whether the primary adjustment has been made in accordance with the arm's length principle. In such a case the other country may not be willing to give the corresponding adjustment and there will be a risk of double taxation. Such a

situation will normally trigger discussions between the tax authorities under the Mutual Agreement Procedure (MAP) contained in tax treaties. The OECD Guidelines provide guidance on the interpretation of the arm's length principle in such circumstances, but it is clearly important that the MAP works effectively and, if agreement between the countries cannot be reached under the MAP, it is desirable to have an effective process in place to resolve the disagreement.

The OECD's most recent work in this area has been carried out by a Joint Working Group on Dispute Resolution (formed from delegates from Working Party No.1 and Working Party No.6) which issued its final report (Improving the Resolution of Tax Treaty Disputes) in February 2007. The report focuses on three major initiatives.

The first is the development of a Manual on Effective Mutual Agreement Procedure (MEMAP). This is web-based and is available online at www.oecd.org/ctp/memap. The MEMAP is intended as a guide to increase awareness of the MAP and how it should function. It is intended to provide tax administrations and taxpayers with basic information on the operation of MAP and to identify best practices for MAP but without imposing a set of binding rules upon Member countries.

The second initiative is the addition to the OECD Model Tax Convention of an arbitration process to deal with the situations where countries are unable to reach agreement under the normal operation of MAP. The Report includes changes to the wording of the Article 25 of the Model Tax Convention, and the commentary on that Article, which will be included in the next update to the Model, due to be published in 2008. The new wording provides for countries to introduce into their treaties a mechanism for binding arbitration if they are unable to resolve an issue within two years of the presentation of the case to (in the example above) the other tax authority.

The third initiative is draft changes to the Commentary on existing Article 25 of the OECD Model Tax Convention to reflect recommendations made in an intermediary progress report from 2004 (Improving the Process for Resolving International Tax Disputes)². These address a number of issues including the conditions and time limit for invoking the mutual agreement process; the denial of access to MAP; the collection of tax during the MAP; the treatment of interest and penalties and the relationship with domestic law.

Business restructuring

A particular area of concern to both tax administrations and multinational companies is that of business restructuring. The term refers to the internal cross-border redeployment, by a multinational group, of its functions, assets and risks, and is often associated with changes in the commercial relationships between group members. A Joint Working Group, consisting of delegates from both Working Party No. 1 and Working Party No. 6, has been considering how the existing guidance in the Transfer Pricing Guidelines, and provisions of the OECD Model Tax Convention, apply to the particular issues encountered in business restructurings. In doing this, the Joint Working Group on Business Restructurings has consulted with business. After a Roundtable that was attended by Delegates from OECD member countries, non-member countries and business representatives in January 2005, a Business Advisory Group, (consisting of academics, business representatives and consultants) was formed and met for the third time in Paris in June 2007, together with government representatives involved

in the project. Members of the Joint Working Group and the OECD Secretariat have also participated in public discussion panels on business restructurings on numerous occasions, and the OECD has through its website solicited private sector input on the issues under discussion.

Business restructuring is a difficult issue. OECD member countries recognise that generally there are valid commercial reasons for undergoing business restructurings and want to avoid creating barriers to normal business processes. For the vast majority of these cases, the objective is for the OECD to provide more clarity about how the existing treaty and transfer pricing guidance should apply, in order to limit the risks of disputes. On the other hand, governments want to tackle “abusive” transactions or those that lack economic substance, and many countries have domestic anti-abuse rules to deal with those. The OECD project, which is looking at the treaty and transfer pricing aspects of business restructurings (but not at domestic anti-abuse rules) is still very much a work in progress and no conclusion has yet been reached. It is hoped that a discussion draft for public comment will be made available by the end of 2008.

Attribution of profit to a PE

The project on the attribution of profits to a permanent establishment provides revised guidance on the application of Article 7 of the OECD Model Tax Convention. Parts I, II and III of the report on the attribution of profits to a permanent establishment (dealing respectively with the issue in general and its particular application to banks and to global trading) were issued in December 2006. A new version of Part IV (dealing with insurance) was issued in August 2007 and a consultation meeting with interested parties held in November 2007. A final version of Part IV is expected to be released in 2008. The conclusions arising from the four-part report will be incorporated into Article 7 and the Commentary on that article. This will be carried out in two stages. The first stage will be to incorporate into the Commentary on existing Article 7 of the Model Tax Convention those conclusions that do not conflict with the existing Commentary. A discussion draft of a revised Commentary to Article 7, incorporating those conclusions, was released in April 2007. The OECD's next step will be to develop new wording of Article 7 itself, together with new Commentary on that Article, which will incorporate the whole revised approach.

Working with non-OECD member countries

It is in the interests of MNEs and governments alike that transfer pricing rules are applied consistently around the globe. To that end, the OECD is continuing its extensive programme to promote the arm's length principle to countries that are developing and implementing transfer pricing legislation. The OECD is carrying on intensive policy dialogue with non-OECD economies on transfer pricing, with the aim to promote consistency of approach not only in legislation, but also in practice. In May 2007, OECD countries agreed to invite Chile, Estonia, Israel, Russia and Slovenia to open discussions for membership in the Organisation³ and offered enhanced engagement, with a view to possible membership, to Brazil, China, India, Indonesia and South Africa. This provides for an historic opportunity to develop close dialogue with these key economies.

Interaction with indirect taxes

An important issue that has been raised by the business community on a number of occasions is the interaction of

transfer pricing rules with indirect taxes, including customs. Both require the valuation of related party transactions, but these are implemented by two different sets of rules and, in many cases, enforced by separate government bodies. These issues were further explored at two joint OECD and World Customs Organisation conferences held in May 2006 and May 2007. These explored concerns over the potential duplicated effort by taxpayers in valuing the same transaction under separate sets of rules and dealing with two sets of government officials. There are also concerns over conflicting interests – increased pricing of inwards transactions gives rise to higher customs duties but lower taxable profits in the importing country. There are also conflicts over the treatment of post-import price adjustments which might be acceptable in some circumstances for transfer pricing purposes, but are not always recognised for customs purposes. The business community has generally expressed interest in an initiative that could lead to less burdensome compliance and more certainty in the application of these two sets of rules. This work is still at an early stage and further consideration will be given to whether it is feasible or beneficial to seek a closer alignment of customs and transfer pricing rules and of their administration.⁴

Future

With the introduction of transfer pricing regimes in countries throughout the world, MNEs are faced with the costs and efforts needed to establish arm's length transfer pricing, as well as the burden of documenting and, in some cases, defending their pricing. Tax administrations are also faced with the cost of administering those rules. One area that the OECD may need to consider further is how the application and administration of transfer pricing rules can be carried out as efficiently and effectively as possible, without giving rise to unduly burdensome compliance costs. These are areas that are at least partly considered in Chapter IV of the Transfer Pricing Guidelines. For example, further consideration might be given to how countries select which transfer pricing issues and cases to take up for audit and enquiry. Other issues that might be considered are how administrative arrangements such as advance pricing agreements and safe harbours might make the tasks of complying with and administering transfer pricing rules easier.

It is well documented that transfer pricing has become, and continues to be, one of the most important, and perhaps most challenging, tax issues facing both MNEs and tax administrations. Transfer pricing is a dynamic topic and new issues will continue to arise. The OECD will continue its programme of monitoring existing guidance contained in the Transfer Pricing Guidelines to ensure that it continues to meet the needs of tax administrations and taxpayers in a changing world.

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This article expresses the views of its author and not necessarily the views of the OECD or its members.

1 www.oecd.org/dataoecd/59/38/36651642.pdf

2 www.oecd.org/dataoecd/44/6/33629447.pdf

3 See www.oecd.org/document/20/0,3343,en_2649_201185_39717140_1_1_1_1,00.html

4 For further information, see www.oecd.org/document/44/0,3343,en_2649_33753_39265324_1_1_1_1,00.html

Important German developments

Alexander Voegelé, Wolf Witt and Jean-Benoit Voegelé
Nera, Frankfurt and New York

The German transfer pricing legislation experienced important developments in 2007. New laws were published on August 14, 2007 and became effective for the procedural parts of the Fiscal Code (*Abgabenordnung*). Changes were also made to the Foreign Transaction Tax Act (*Außensteuergesetz*). These changes are effective for the assessment period regarding the year 2008.

Several parts of the new legislation can be regarded as clarification of existing laws and are thus also applied for prior years; for example, guidance regarding the value determination when business is migrating.

Important changes to general principles

Presentation deadline for the documentation

Section 90 (3) AO shortened the presentation deadline for the documentation of exceptional business transactions to 30 days. For standard business transactions, the deadline for the presentation of the documentation of 60 days remains unchanged. Section 162 (3) AO introduces sanctions in the case of refusal of co-operation by foreign related persons, even when presenting utilisable documentation.

Burden of proof

Section 162 (3) S.3 AO shifts the burden of proof to the tax payer. If there is an indication for a diminution of income in a German subsidiary and if these doubts cannot be cleared – because a foreign related person does not exercise his documentation duties (Sections 90 (2), 93 (1)) – the less favourable point in the range of estimates can be used by tax authorities in order to assess the taxable income. This also applies to cases in which the taxpayer has actually presented a documentation of its applied transfer prices to the authorities.

The prior BFH court decision from October 17, 2001, BStBl. II 2004, 171 concerning the documentation responsibilities of German subsidiaries can be summarised as follows: In general a subsidiary is not in the position to force its parent company to deliver documents. Caveats may only exist when such delivery of documents is common between independent third parties. However, independent third parties regularly do not disclose their profit calculations to their business partners. In general, a subsidiary also does not have the actual power to force a parent company to provide certain information. Therefore, the burden of proof has traditionally been with the tax authorities.

Also the prior BMF letter dated April 12, 2005 on the documentation responsibilities of a German subsidiary (BStBl. 2005 I 570, Tz 3.3.2 ff) stated that a subsidiary only has to prove that the parent company did not deliver information/documentation. The BMF letter stated that foreign parent companies had to deliver documents only in cases

where the cost plus or resale price method were applied, or in cases where the intercompany transactions involved intellectual property (e.g., licenses for IP), profit split arrangements, or cost pooling arrangements.

This situation was regarded as unacceptable by a multitude of tax inspectors. The new law – especially the shift of the burden of proof to the tax payer – will change the situation of transfer pricing audits dramatically. The new rules represent a revolutionary development in German tax law. Strong objections under constitutional law exist.

Changes regarding the GAufzV

Section 3 (2) GAufzV (profit allocation records ordinance) introduces the contemporary documentation for cost sharing arrangements. Section 5 S.2 of this ordinance requires the documentation in case where R&D activities are relocated. Such documentation is required if the taxpayer commonly performs R&D activities and records for R&D projects are anyway established for non-tax reasons.

Concurrence of AStG and other laws

Section 1 (1) S. 1 and 3 AStG (Foreign Transaction Tax Act) determine that Section 1 AStG applies irrespective of other laws, that is, it is a “replenishment law”. Section 1 AStG captures the difference between the arm’s length price and the amount revised by other regulations (cp. Tz 1.1.2 Circular on the application of the AStG, BStBl. 2004 I special issue 1/2004). The legal changes apply in particular in the concurrent cases of Sections 39-42 AO, e.g. balance sheet corrections, withdrawals, hidden contribution, and constructive dividends.

Example:

The partial value applies to hidden contributions; this value is often lower than the arm’s length price. In such cases, the higher arm’s length price as required by AStG is replenishing the partial value.

From the point of view of the German fiscal authorities, the changes do not represent a new law, but must be considered as a clarification of the existing legal situation.

Information transparency

New Section 1 (1) S. 2 AStG assumes information transparency. This leads *de facto* to the rejection of the arm’s length comparison of the behaviour of the prudent business man in favour of the arm’s length comparison of the results. As a consequence, this new paragraph is leading to the Anglo-Saxon approach of benchmarking results. Through this, German legislation and long-lasting jurisprudence changes profoundly.

Ranking of methods

Section 1 Abs. 3 S. 1 AStG states the priority of the standard methods in case of entirely comparable data. Apart from the

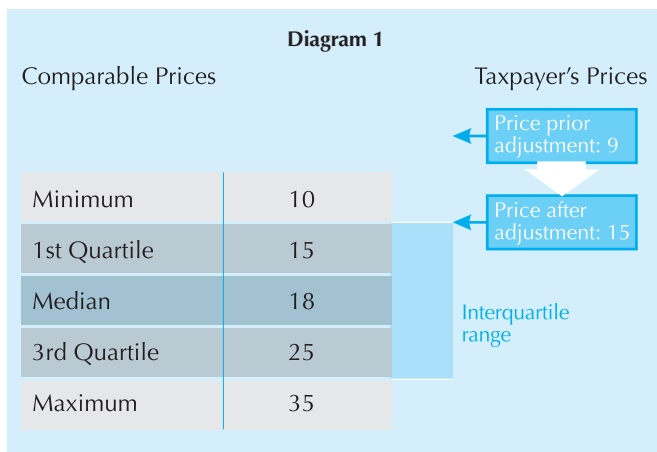
financial services sector, this new article will not have a high importance since entirely comparable data is usually very difficult to identify.

Range of margins

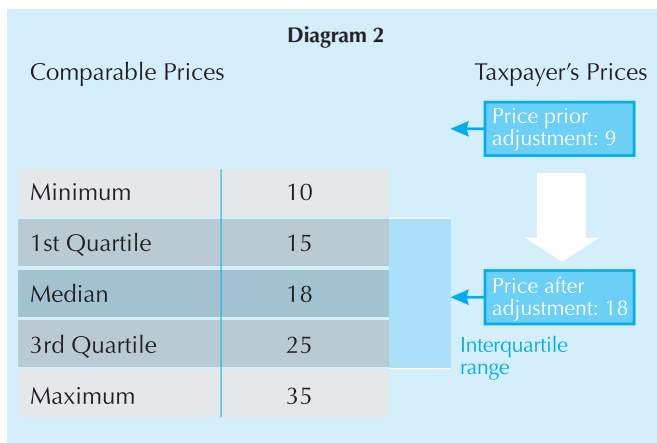
Section 1 Abs. 3 S. 2 AStG states that not entirely comparable data can be used for tax purposes, if the range of comparable external data is narrowed, for example by an interquartile range (Section 1 Abs. 3 S. 3 AStG).

Extent of an adjustment to the median

Under the prior jurisdiction (BFH from Oct 17, 2001, BStBl 2004 II 171), transfer pricing adjustments were accepted only to the most favourable value of the entire range. This means that – to the advantage of the taxpayer – too low prices were usually adjusted to the first quartile of the identified interquartile range. The same would apply for too high prices that are adjusted to the third quartile – see Diagram 1.



From the assessment period 2008 onwards, adjustments have to be made to the median of the identified range (Section 1 Abs. 3 S. 4 AStG) – see Diagram 2.

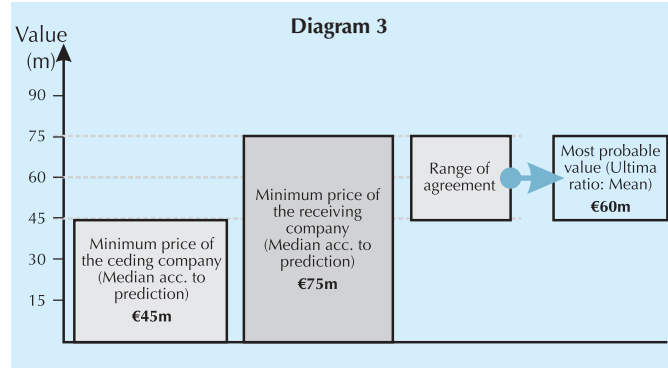


Range of comparables (Section 1 Abs. 3 S. 5-6 AStG)

If direct comparables do not exist – as is usual in the case of relocation of functions or the transfer of intangibles – the range of comparables has to be estimated and the minimum and maximum prices that the business partners would accept have to be determined.

This means that transfer pricing adjustments will predominantly be higher than under the old regime.

Within this price range, the most probable value is applicable. As an ultima ratio the mean has to be applied – see Diagram 3.



The new law on business migration – relocation of functions

International trend

The OECD formed a common working group of WP 1 and 6 in order to address transfer pricing issues connected to the migration of businesses. A discussion draft is expected by the end of 2008. Germany enacted world-wide the first specific law on the relocation of functions. The U.S. Section 1.482 regarding the relocation of IP was a precursor to this new development.

The new German legislation concentrates on the relocation of functions – the “transfer package” – and its profit potential. A function is an organic part of a company and must not necessarily be an entire division. However, transferable functions usually represent an aggregation of homogeneous tasks, which may be executed by particular units or divisions of a company.

The relocation of a function includes the assets necessary for performing it, as well as the connected opportunities and risks. In this respect, “relocation” means transfer from one company to another affiliated company or to a permanent establishment. Temporary or partly transfers may also be deemed “relocations”.

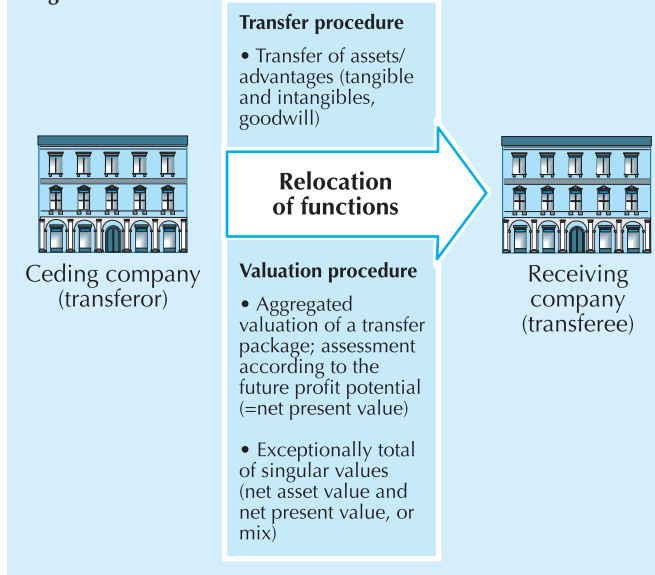
The “duplication” (instead of relocation) of functions may be treated independently but with comparable effects (Section 1 Abs. 4 Draft FVerlagVO as of October 2007).

No relocation exists in cases of the divestiture or cession of single tangible assets, the supply of a singular service or the expatriation of employees without the transfer of functions or intellectual property. The definition of the “relocation of functions” is broad and covers various relocations of tasks. The preamble of the new law aims at securing the taxation of assets produced in Germany, when intangible assets and advantages (know-how, patented or unpatented knowledge, trademark rights, customer base etc.) are relocated abroad.

The transfer package

The relocated function has to be valued on its total value that drives from its transferred future profit potential. The stand-alone values of assets can be used in exceptional cases, if no significant intangible property is relocated, or if both valuation approaches exist and where the total of stand-alone values is closer to the arm’s length price. (See Diagram 4)

Diagram 4



Valuation of the transfer package

The net present value of future earnings has to be determined for the ceding and the receiving company. When third-party comparable prices cannot be determined, the law provides for a hypothetical third-party comparison. For purposes of such a hypothetical third-party comparison, the minimum price that the transferor would be willing to accept and the maximum price that the receiving party would be willing to pay need to be determined by means of a functional analysis and internal business projections.

The price reflecting the arm's length principle with the highest probability within the so-called "range of agreement" should be used in general. If no such *prima facie* evidence is available, the arithmetic mean between the price minimum and maximum may be used. The rationale behind this method is that the median best approximates the results of fictitious negotiations between two third parties.

The range of values for the relocation of functions (transfer package) has to be determined through the transferred profit potential in its entirety using a method which is based on the capitalised earnings value.

According to Section 1 Abs. 6 FVerlagVO, the profit potential derives from the expected after-tax profit. The calculations must also respect advantages from location savings and synergy effects (Section 2 Abs. 1 S. 5 FVerlagVO). An appropriate interest rate and a reasonable capitalisation period have to be applied.

When determining the profit potential, a multitude of aspects have to be taken into consideration. The relocation of functions does generally not lead to an isolated use of the transfer package. The transfer package usually represents only a part of the income of the transferee. The transferred functions are generally supplemented by further functions and vary in their absolute and relative value over time.

When calculating the minimum price that the ceding party is willing to accept, the legal and economic ownership of the transfer package have to be investigated, the lifetime of the package on the date of the transfer has to be verified, the future associated earnings have to be quantified and various other elements need to be considered such as the market

development, the economic situation, gestation lags, decay rates, and appropriate amortisation rates.

When calculating the upper limit of the price range, the contributions of the receiving party have to be analysed, for example its own IP and workforce. The future associated earnings have to be quantified taking into consideration the market development, gestation lags, as well as decay, amortisation and interest rates.

Finally the bargaining power of the involved parties has to be analysed in order to determine which price within the min-max range would be the most likely negotiation outcome between independent third parties.

When analysing and calculating the arm's length price for a transfer package, accepted valuation methods should be used as for example the Residual Profit Split, the Contribution Profit Split (e.g., in the automotive industry), and the Comparable Profit Split (e.g., in the pharmaceutical and banking industry). Other accepted valuation techniques are cost based contribution analyses, expert survey systems (e.g., concerning know-how and market power), and consumer survey systems (e.g., for brand value).

Periodical adjustments

When intellectual property is transferred, if comparables do not exist and if the actual profit development differs substantially from the predicted development, there is the rebuttable presumption that external third parties would have agreed on an appropriate price adjustment clause. An adjustment applies after the financial year in which the substantial deviation occurred. The period under consideration is 10 years. Price adjustments are not necessary in the case of a profit-dependent licensing of the transfer package.

A deviation between the predicted and the actual earned profit is *substantial*, if the new price, which would have been agreed on as a result of the actual development between independent third parties, is outside the original range that was calculated based on the original assumptions regarding the profit development.

The minimum price required by the transferor stays *unaffected* when quantifying potential adjustments.

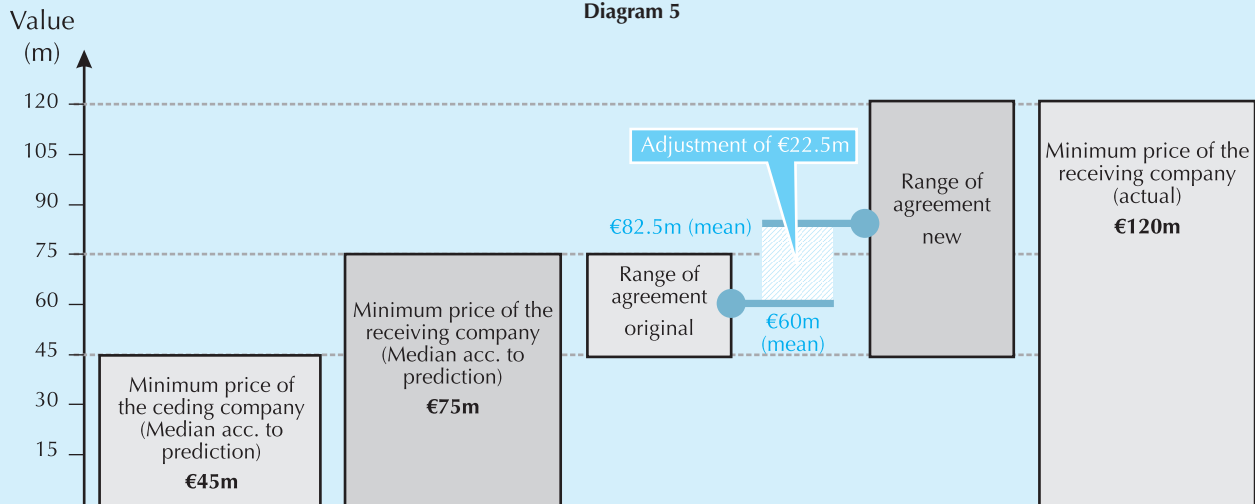
Periodical adjustments example – profit explosion

This is illustrated in Diagram 5 on page 12.

If it is later discovered that prior price-relevant or valuation-relevant factors were substantially inaccurate, a rebuttable presumption arises that at the time the transaction was executed, the price agreement was subject to uncertainties and independent third parties would have agreed upon periodic adjustments.

The taxpayer may, however, prove that independent third parties in the same situation would not have agreed upon any adjustment mechanism. If the taxpayer cannot satisfy the burden of proof and a substantial discrepancy is discovered within the first 10 years from execution of the transaction, the price is subject to a one-time adjustment. The adjustment must be made in the year following the year in which profits did not develop as expected.

Diagram 5



No price adjustment for the benefit of the taxpayer

An automatic ex-post correction for the benefit of the taxpayer is not allowed according to ASTG (cp. Section 1 (1) S.1 ASTG).

Periodical adjustment example – profit diminution

This is illustrated in Diagram 6 below.

It is therefore advisable that the taxpayer initiatively arranges a price adjustment clause in the transfer agreement, which is effective in both directions. Otherwise ex-post corrections may be possible through other regulations (e.g., “deemed contribution”), by Mutual Agreement Procedures through the Competent authority (Section 175a AO), or through by arbitration procedures.

Prior losses

When determining the value of the transfer package, it is not decisive whether the transfer package actually is, or was, profitable for the transferor.

Other aspects

Cases of minor significance can be valued differently. However, this escape clause requires that no material intangibles or benefits are transferred or licensed along with the business

function. A valuation of individual assets is permitted if the taxpayer presents *prima facie* evidence that the total value of individual assets more properly reflects the arm's length principle.

According to the legislative rationale for the law, the above principles may be also used for the planning of business functions shifted to Germany.

Unlike the other provisions of the Corporate Tax Reform Act, rules for transfer prices and relocations of business functions will apply for the first time in the 2008 tax assessment period.

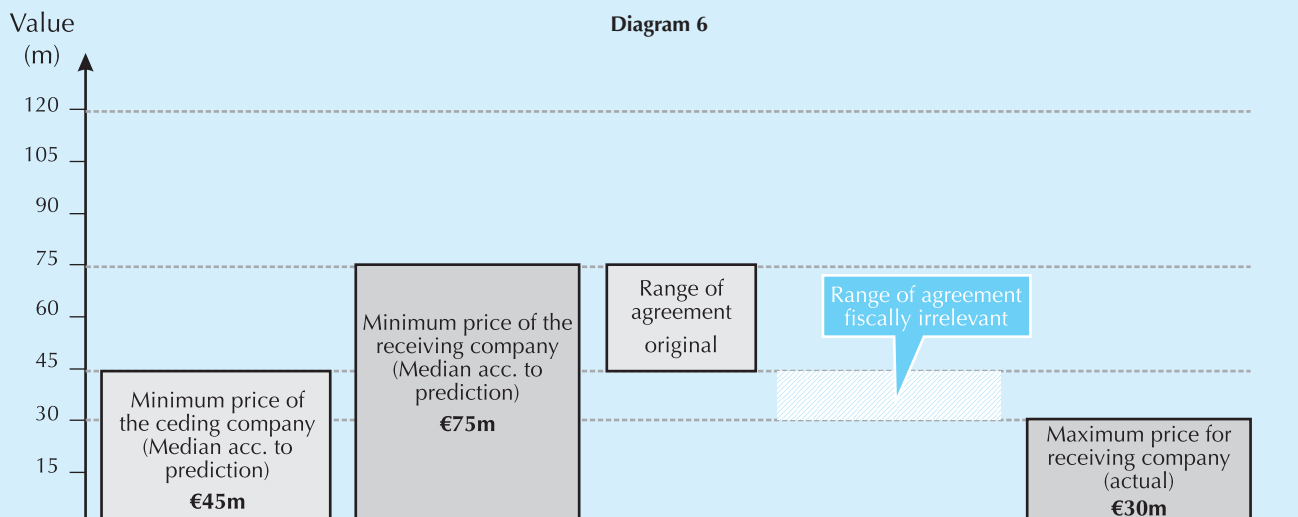
Conclusion

Both, the important changes of general transfer pricing principles as well as the law on the relocation of functions will have an important impact on the transfer pricing of the entirety of companies having their headquarters or subsidiaries in Germany. The partial shift of the burden of proof to the taxpayer and the taxation of the relocation of functions will generate major difficulties.

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Diagram 6



Developments in Latin America

Baker & McKenzie, Latin American Team

This series of short articles, co-ordinated by Moisés Curiel, examines the current transfer pricing situation in a number of Latin American jurisdictions.

Argentina

Martin J. Barreiro and Silvana M. Yanichevsky

During 2007 Argentina did not experience major changes with respect to the transfer pricing regulations. Nevertheless, there were some changes in the judicial interpretation of such rules as well as of the remaining provisions of the local Income Tax Law and its Regulatory Decree which, as will be explained below, were applied with much more flexibility to cases involving related parties in lieu of the applicable commentaries of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).¹

One of these changes could be seen in the resolution of the appeal that the Court C of the Federal Tax Court made in the case “Compañía Ericsson S.A.C.I.”, on August 15, 2007.

Formerly, on November 13, 2002 the Federal Tax Administration (“FTA”) published out its resolution – that was appealed by the taxpayer – where it assessed an Income Tax Deficiency for 1996 and 1997 taxable years (when the amendment to the Transfer Pricing rules had not yet taken place), regarding transactions of the local subsidiary of a foreign company. The FTA considered vital the written documentation of the loan in order to give enough certainty that the transaction was made between unrelated parties. Indeed, the FTA resolution was made based on the lack of:

1. documentation of the loan that had been given by Ericsson Treasury Service of Switzerland to Ericsson’s local subsidiary – the only “document” that existed was an unsigned memo;
2. guarantees and/or co-signers; and
3. authorisation for taking such loan by a minute of the Board of Directors, as the normal practices impose for transactions entered into between unrelated parties, despite the amount of the loan involved and the high level of indebtedness of the company.

The Federal Tax Court (“FTC”) concluded that the FTA’s decision – where it considered that the loan taken by an Argentine entity from a foreign one, from the same economic group, had not been made under the arm’s length standard – should be revoked.

In order to arrive to such conclusion, the FTC mentioned Section 14 of the Income Tax Law (ITL), which provides the “independent third party” concept. In other words, the ITL settles that every transaction entered into among local or foreign taxpayers as well as with related parties/entities located, domiciled or constituted abroad, will be considered for Income

Tax purposes, as entered into between unrelated parties as long as its term and conditions will be in line with the arm’s length standard. The FTC also made reference to Chapter I, paragraph 1.10 of the OECD Guidelines, that regarding such principle recognises a difficulty in putting such principle in practice since related parties may start up businesses or transaction that they would not do with unrelated ones.

In addition, paragraph 1.29 of Chapter I of the OECD Guidelines provides that the explicit and the implicit terms of the agreements that frame a transaction are the ones that define the responsibilities, risks and benefits to share between the unrelated parties involved; but it also provides that such terms may also come from the communication and postal affairs between such parties, and sometimes even more than from the agreement itself. The FTC believed that the latter is what had happened in this particular case, and that it is worldwide recognised as a regular practice among related parties.

Furthermore, such commentary explains that the discrepancy of interests does not take place in transactions between unrelated parties and, thus, it is important to determine whether their behaviour is consistent with the terms of an agreement or if such conduct shows that the contractual terms were not in line with the arm’s length standard.

The FTC believed that such requirement was met in this particular case because, due to the nature of the agreements or transactions between related parties, they may or may not comply with the same formal requisites as the ones entered into between unrelated parties. The FTC considered that in transactions between related parties it is more suitable an analysis of the actions pursued by the parties in order to determine the terms of such transactions.

Consequently, in Ericsson’s case, such analysis have not led to an avoidance conduct by the parties, since they were in line with the arm’s length standard (i.e., the ones that would have been followed by unrelated parties), specially when the loan was replaced by a new one taken from an unrelated local bank and under similar conditions.

The significance of this case is grounded on to the flexibility given by the FTC of the requirements that for income tax purposes, the Income Tax Law, and its Regulatory Decree, sets forth for the loans when they are performed between related parties. In addition, the economic reality is expressly applied in this case, where the analysis was made, almost entirely, with respect to the conduct of the parties regardless the form as well as the formality of the transaction.

Brazil

Clarissa Machado

No major changes were implemented in the Brazilian transfer pricing legislation during year 2007, except that for the third

consecutive year, a ruling and an ordinance have been enacted, aiming at reducing the potential adverse effects on the transfer pricing calculations caused by the appreciation of the Brazilian currency (Real) against the U.S. dollar during 2007.

As in the previous years (2005 and 2006), the Brazilian Federal Revenue Service published Ordinance 329/07 and Normative Ruling 801/07 (published on December 28, 2007), allowing taxpayers subject to the Brazilian transfer pricing rules to adjust the export revenues recorded in 2007 by a factor of 1.28.

The possibility of adjusting up the export revenues applies to the following cases:

1. comparison with uncontrolled local price in order to determine whether the 90 percent threshold has been achieved for purposes of applicability of the transfer pricing rules on the exports,
2. comparison with the parameter price, in case the taxpayer has elected to use the Production Cost plus 15 percent Profit Margin Method ("CAP"), and
3. calculation of the average profit margin for 2005, 2006 and 2007 in order to apply the five percent net profit "safe harbour".

In addition, following the rules applied in 2005 and 2006, the normative ruling listed above include the option of calculating the five percent net profit "safe harbour" for the 2007 calendar year considering the results recorded by the tax payer in 2007 only, rather than using the three-year average established by the Brazilian regulations.

Chile

Sergio Illanes and Miguel Zamora

The rules for transfer pricing were originally introduced to the Chilean income tax law (ITL) back in 1997. Such rules are brief and traditionally have been said to follow the OECD Guidelines, for example, they incorporate the arm's length principle as the standard to measure transfers of values among related parties. No important regulations have been issued since its creation and it has not been clear to experts what methods are acceptable and if the OECD Guidelines are applicable to Chile, considering that Chile is not a member of the OECD. In addition, there have been few TP cases and the audits in which TP was used have not been successful.

During 2007 the team of professionals exclusively designated to TP within the SII has been enhanced and their current approach is that the OECD guidelines are applicable in Chile with no restriction and that all the methods contained in such regulations are as well applicable in Chile. This new approach probably reflects that Chile has been invited to become a member of the OECD and that changes and updates have to take place in Chilean tax legislation including TP matters within the process of incorporation to the OECD. This team of professionals is aware of the usefulness of the TP scrutiny, particularly for Chile, considering the importance of the foreign investment and that many multinational enterprises do business in Chile and have a formal presence.

Therefore, we anticipate that in 2008 the work of these professionals is implemented as an important part of audits being conducted to key taxpayers and areas of businesses, for example, buy and sell structures and industries such as mining, pharmaceutical and services in general. We also expect that rules are drafted regarding key TP aspects such as the definition of related parties, safe harbours, TP studies and perhaps APAs or some form of them.

Colombia

Diego Gonzalez-Bendiksen and Angelica Parga

Year 2007 was a very interesting year for transfer pricing in Colombia. Before having to file the 2006 information returns, taxpayers were obliged to update their Tax Unique Registry (RUT) in order to be capable of filing. Any taxpayer that did not update its RUT could not file its information return. With this, the Colombian Tax Authority (DIAN) is trying to consolidate information of its taxpayers through the use of different tools.

In terms of filings, taxpayers complied with the formal obligation of filing their 2006 electronic information returns for the second year in a row. The novelty was that information returns had been modified by the DIAN and the new ones were much better organised and user-friendly, in terms of information on related parties, types and amounts of transactions, interquartile range and tested party. The information returns were filed throughout June, depending on the last digit of the taxpayers' identification number. To several taxpayers who did not comply with the filing dates and filed extemporaneously, penalties applied; some taxpayers were requested to file by means of an official DIAN requisition, and some filed voluntarily. In both cases, penalties were calculated for filing extemporaneously.

Regarding audit and control procedures, the DIAN requested several taxpayers to file their 2005 and 2006 transfer pricing studies. Penalties also apply in case taxpayers do not comply with the DIAN's requisition. So far, no big issues have arisen.

Even though throughout years 2006 and 2007 the compliance audit tool used by the DIAN has been the collection of information returns and transfer pricing studies, it has been preparing itself to conduct in-depth audit procedures, which are very likely to be launched at the beginning of 2008.

Ecuador

Diego Gonzalez-Bendiksen

Regarding transfer pricing, most of year 2007 was pretty calm in Ecuador. Taxpayers complied with all formal obligations:

1. during the months of April and May, the new electronic information returns for fiscal year 2006 we filed before the Ecuadorian Tax Authority (SRI) in the stipulated formats;
2. during the month of October, taxpayers filed their transfer pricing studies (*Informe Integral*).

Based on the previously stated, the Authority has kept up the audit and control process to determine taxpayers who comply, or not, with both filings.

In late 2007, a Tax Reform Proposal that includes some transfer pricing issues was submitted to Congress. In the Proposal, the following issues are outstanding:

1. there is a major interest in providing transfer pricing the hierarchy of a Law, instead that of a Regulatory Decree (that it actually is). Aspects such as the Arm's Length Principle, Comparability Criteria and Methods would be included as Law;
2. since there exists no particular penalty regime, maximum penalties of up to USD15.000 would apply for failing to file the information return and the transfer pricing study, filing with errors or filing information that differs with information filed in the Income Tax Return;
3. domestic-based transactions would have to be evaluated in a transfer pricing study.

There is a great expectation in Ecuador as to the approval of items 1) and 2), for which the Congress will have to pronounce itself shortly.

Even though throughout years 2006 and 2007 the compliance audit tool used by the SRI has been the collection of information returns and transfer pricing studies, it has been preparing itself to conduct in-depth audit procedures, which are very likely to be launched at the beginning of 2008.

Mexico

Moisés Curiel

Several changes were made to the Tax Administration Service (SAT) with the entry of the new government (Felipe Calderón) in 2007. One such change was to replace the Central Transfer Pricing Audit Administrator (Roberto Schatan) with a new Central Administrator, Luis Eduardo Natera Niño de Rivera. This represents a different approach to cases, conclusions and the authority's dynamic with respect to audits and advance pricing agreements. While a majority of team members remain, the presence of a new Central Administrator is generating greater results in the department, for two key reasons.

The first reason is the October 22, 2007 issuance of new SAT Internal Regulations, designating 10 new deputy administrations under the Central Administration, increasing the total number from six to 16 deputy administrations. The department name was also changed, to the Central Pricing Inspection Administration from the prior Central Pricing Audit Administration. This is in line with the department's actual activity; in addition to managing audits, the department also handles APAs.

The second aspect is the application of the Mexican Government's tax amnesty programme, whereby the Central Pricing Inspection Administration ruled, in December 2007, on a number of complex cases of transfer pricing adjustments. In general, the amnesty offered by the new government reduced taxpayer assessments by up to 80 percent, including 100 percent of penalties and surcharges. This reduction, combined with the fact that the payment does not create a precedent for taxpayer acquiescence, led several companies to withdraw their court cases or administrative appeals, opting instead to pay the reduced amount available under the amnesty programme.²

Article 213 of the Income Tax Law was amended to authorise the tax authorities, in or after 2008, to determine simulation for tax purposes, without requiring a court finding of simulated acts.³

The risk is that the SAT is empowered to determine simulation based on presumptive elements. However, the authority must provide appropriate grounds and reasoning for its actions, identifying the allegedly artificial act and quantifying it against the actual intent. This new power will enable better taxpayer negotiations from the SAT's point of view, to avoid the assessment of criminal liability.

In legislative news, Mexico passed a new law establishing the Single-Rate Business Tax (IETU), in effect from 2008. This tax acts as an alternative minimum tax in lieu of the repealed asset tax,⁴ payable by taxpayers that do not have income taxes owed. The law disallows the deduction of interest and royalties paid to related parties, and provides transfer pricing rules for related-party transactions. A decree providing IETU incentives for maquiladoras was also issued.⁵

Mexico is continuing in its brisk pace of transfer pricing audits. It is now looking beyond pharmaceutical companies, with an eye towards electrical products distributors, consumer product manufacturers (especially in the case of corporate restructurings), and companies with aggressive approaches such as debt push down and migration of intangibles.

As regards APAs, late last year the SAT authorised the first two thin capitalisation APAs, allowing a debt-to-capital ratio above the proportion allowed in the Law.⁶ This is an innovative step for Mexican tax authorities.

Competent authority proceedings have also been carried on with Japan, the United States and Canada. These proceedings are increasingly being used to reduce possible double taxation by way of transfer pricing adjustments, in Mexico and worldwide.

The New Year will see a great deal of activity by the authorities in regard of audits and APAs alike, as the tax authorities receive the relevant training and material resources.

Peru

Claudia González-Béndiksen

During 2007, Peruvian taxpayers had to prepare their Transfer Pricing Technical Study for fiscal year 2006, with certain information requirements according to article 117 of the Peruvian Income Tax Regulation (PITR). Also, following article 116 of the PITR, taxpayers had to have information and documentation that support the transfer pricing calculations.

The Peruvian Tax Authority (SUNAT) sent requirements to several taxpayers asking for the 2006 Technical Study. The required taxpayers had to file the 2006 Technical Study to SUNAT no later than twenty calendar days after receiving the requirement.

Regarding the annual sworn information return, Form 3560 was released by SUNAT on April 16, 2007. The filing dates were set for July 2007, but were postponed twice, with the final filing dates starting on December 10, 2007, according to the last digit of the taxpayers' tax identification number.

Even though taxpayers could have entered into advance pricing agreements (APAs) with the Tax Authority as of 2006, there has not been any information about any APAs being agreed upon between any taxpayer and SUNAT.

For the coming years, more Technical Study requirements are expected. Also, it is very likely that SUNAT will start Transfer Pricing audits.

Venezuela

Fernando Cruz

The Law for the Partial Reform of the Income Tax Law ("IT Reform Law"), published in Official Gazette Number 38.628 of February 16, 2007, modified the 2006 VITL. The IT Reform Law, limited to two articles, included the rules on thin capitalisation for the first time in Venezuela for the purposes of deducting interest on loans between related parties.

While the IT Reform Law did not specify the term that shall elapse prior to its entering into effect, according to articles 8 of the Organic Tax code and 217 of the Constitution, when the tax law does not set a term that shall elapse prior to its entering into effect (*vacatio legis*), said term shall be deemed to be 60 calendar days. Consequently, the Reform Law became effective on April 16, 2007, and will only apply to the fiscal years that began and will begin after that date.

According to the IT Reform Law, when a taxpayer assumes a debt, directly or indirectly, with a related party, that debt, unless contracted under market conditions, will be treated as net worth for all legal purposes, even if the total amount of the taxpayer's debts does not exceed the amount of its net worth. To determine if a debt was assumed under market conditions, the following circumstances should be considered:

1. the taxpayer's level of indebtedness,
2. the possibility of the taxpayer obtaining a loan in an arm's length transaction;
3. the amount of the debt that might have been obtained in an arm's length transaction without the involvement of the related party;
4. the interest rate it would have obtained in an arm's length transaction without participation of the related party, and
5. the terms and conditions it would have obtained in an arm's length transaction in which the related party was not involved.

High audit activity is to be observable in the near future. Recent transfer pricing information requests have been issued to several companies, specifically in the pharmaceutical, automotive and oil and gas sectors. The recent Transfer Pricing Division's move to the Inspections Office is intended to give way to new pricing audits through in-depth reviews and enforcement of taxpayer obligations.

Uruguay

Jonas Bergstein and Domingo Pereira⁷

On July 1, 2007, the transfer price rules started in Uruguay. The new law ("Act") introduces comprehensive legislation, mainly patterned after the OECD guidelines. Although the Act rules are yet to be implemented by regulations to be

issued by the Executive Branch, the Act establishes certain major underpinnings summarised below. The transactions between related entities are deemed to be operations as effected between non-related companies, as long as the terms and conditions are in line with standard market practices for non-related enterprises (arm's length). Further to the Act, it is deemed that the parties to the transaction are related, where

1. one of them is a foreign entity (or operates under a special customs regime, so-called "exclave aduanero"), and
2. the parties to the transaction are subject to the direction or control by the same individuals or legal entities.

Under the Act, transactions between Uruguayan based Income Tax taxpayers and companies based in one of the low-tax-jurisdictions (to be listed by the Administration), will be presumed not to meet the arm's length standard and therefore will be subject to review as indicated next.

The Tax Office has the burden of proof to show that the terms and conditions of any given transaction do not meet the arm's length principle as referred above. If the arm's length standard as defined above is not met, the Tax Office is allowed to re-establish the transaction arm's length price (and re-assess applicable taxes accordingly), in conformity with the rules set forth below.

For purposes of reviewing and adjusting the transaction price, the Act contemplates the application of the comparable uncontrolled pricing or CUP method, the re-sale pricing method, the cost plus method, the profit split method, and the transactional net margin method, which shall be applied in the manner to be established by relevant regulations. For purposes of determining the applicable prices "reasonably consistent with market practices", taxpayers shall be required to provide the Tax Office with all relevant information which regulations may require, including without limitation costs-allocation criteria, profit margins and any other data the Administration may deem appropriate.

For import-export transactions which relate to goods subject to transparent and publicly known prices (such as stock exchanges), such publicly known prices shall be considered to determine the locally sourced income, unless there is evidence to the contrary. The Executive Branch is also authorised to establish mechanisms to determine the presumed locally-sourced income, considering the specific circumstances of each case and the nature of the respective business; in those cases, taxpayers shall have the option to benefit from such a pre-established mechanisms ("safe-harbours").

- 1 OECD, Paris, 1995.
- 2 Amnesty applied only if the respective amount was paid in 2007, maintaining the 80 percent discount on tax debts preceding 2003. For later years, only surcharges and penalties are abated.
- 3 Simulation is defined as the apparent alteration of the cause, nature or actual purpose of an act or agreement.
- 4 16.5 percent in 2008, 17 percent in 2009 and 17.5 percent in 2010.
- 5 The benefit of IETU rules for maquiladoras will be explained in a forthcoming article.
- 6 Debt-to-capital ratio of 3 to 1.
- 7 Estudio Bergstein in Montevideo, Uruguay

Developments in the Netherlands

Clive Jie-A-Joen and Jeroen Geevers
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This article provides an overview of the transfer pricing developments in the Netherlands in 2007.

Transfer pricing rules and guidelines in the Netherlands

Effective January 1, 2002, Article 8b of the Dutch Corporate Income Tax Act 1969 ("CITA") that codifies the arms length principle and introduces transfer pricing documentation requirements in the Netherlands, came into force. Article 8b CITA basically provides that where enterprises are associated and conditions (transfer prices) are applied between these enterprises that independent enterprises would not apply, then the (reported) profits may, for tax purposes, be adjusted taking into account conditions (transfer prices) that would have been agreed between independent enterprises. The third paragraph of Article 8b formally requires Dutch enterprises to prepare transfer pricing documentation if they are involved in transactions with associated enterprises.

In the Netherlands, further guidance regarding the interpretation and application of the arm's length principle and documentation requirements is provided by the Dutch transfer pricing guidelines (as published by the Under-Minister of Finance in Decree of 30 March 2001,¹ updated with Decree of 21 August 2004²), and the OECD TP Guidelines.³ The Dutch transfer pricing guidelines explain the position of the Dutch Tax Authorities regarding the application of the arm's length principle and the OECD TP Guidelines. For further details on the Dutch transfer pricing regulatory framework reference is made to our previous article on the Dutch transfer pricing developments up to and including 2006.⁴

Dutch APA practice

On April 1, 2001, the Dutch ruling practice was converted into an Advance Pricing Agreement ("APA") and an Advance Tax Ruling ("ATR") practice. Table 1 presents an overview of the APA / ATR requests filed, the number sustained, the number rejected and the number of requests withdrawn / not currently dealt with for the years 2005 and 2006.⁵ At the date of publishing this article, the numbers for 2007 were not yet published.

Although the 2007 number are not yet available, a comparison between the 2005 and 2006 numbers shows that the number of APA requests dealt with and sustained by the Dutch tax authorities both significantly increased, while the average process time of requests slightly decreased.

Table 1

2006	<i>Total dealt with</i>	<i>Sustained</i>	<i>Rejected</i>	<i>Withdrawn/ not currently dealt with</i>	<i>Average process time of requests (days)</i>
APA	237	176	4	57	53
ATR	373	316	15	42	42
Other / grand-fathering period	3	2	0	1	
Total	613	494	19	100	
2005					
APA	119	86	10	23	66
ATR	241	196	15	30	40
Other / grand-fathering period	14	11	1	2	
Total	374	293	26	55	

Dutch Tax Authority transfer pricing audits

In this section our experience on the Dutch Tax Authorities' approach in practice, with respect to executing the Dutch legislative transfer pricing framework, is presented.

In 2007 Ernst & Young commissioned Consensus Research International to conduct independent interviews with 850 MNEs across 24 countries, one of them being the Netherlands, amongst others presenting MNEs experience with transfer pricing audits.⁶ General developments that can be recognised are:

- inter-company services have replaced tangible goods transactions as the most common form of transactions reviewed by auditors;
- in audit cases resulting in adjustments, parent respondents indicated that tax authorities threatened to impose penalties in 31 percent of the cases, and penalties were actually imposed in 15 percent of the cases; and
- parent respondents reported that tax authorities requested access to operational personnel in 36 percent of examinations.

As regards the Netherlands, the 2007 Survey results show that Netherlands-headquartered companies are the most vulnerable to transfer pricing audits, with 84 percent having experienced an examination since 2003 somewhere in the world. This may be due in part to the Dutch tax authority's having established a dedicated audit enforcement team in recent years. Furthermore, 24 percent of the Dutch parent respondents stated that the revenue authority threatened to impose penalties. In addition, 92 percent of the Dutch respondents indicated that it is "fairly likely" or "very likely" that a transfer pricing audit will be carried out in any part of their organisation in the next two years.

With respect to transfer pricing audits conducted by the Dutch tax authorities, it is recognised that a functional

analysis is incorporated into many of these audits and forms the basis of transfer pricing risk analysis of taxpayers. The Dutch tax authorities request for transfer pricing documentation reports in light of the Dutch transfer pricing documentation requirements, which was effective as of January 1, 2002. The burden of proof is shifted to the taxpayer if taxpayer does not satisfy transfer pricing documentation requirements. The Dutch tax authorities are in particular focused on the alignment between functions performed and risks assumed and resulting remuneration.

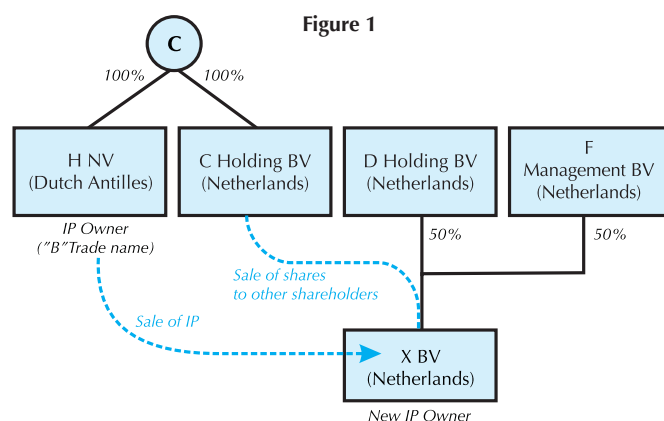
Court cases published in 2007

Litigation on transfer pricing cases is still not common in the Netherlands. This section, however, discusses three transfer pricing (related) Court cases published in 2007, which were all won by the Tax Inspector. Two Court cases involved inter-company transactions of intangible assets in which the burden of proof ultimately rested on the taxpayer.

Dutch Supreme Court on the purchase price of IP⁷

Facts of the case

The shares in the capital of the Dutch corporate income taxpayer (X BV) are owned by C BV (shareholder C), D BV (shareholder E) and F BV (shareholder G) (all 33 percent). All group companies use the word "B" in their trade name. The B brand (the B trade name and logo) is exploited by H NV, located in the Netherlands Antilles. Further, the shares in the capital of H NV are owned by C, being the ultimate shareholder of C BV. Subsequently, D BV and F BV acquire the shares in the capital of X BV from C BV for an amount of €1,361,341. Additionally, it was agreed upon that X BV would acquire the B brand from H NV for the same amount. The Tax Inspector stated that the B brand did not have any value and that the depreciation claimed by X BV in the fiscal year 2000 Dutch corporate income tax return on the B brand should be corrected. The simplified structure after the transactions can be depicted as shown in Figure 1:



In subject case, X BV had the burden to prove that a comparable independent third party under similar circumstances would have paid a similar amount for the subject brand, since the Tax Inspector properly motivated that the value of the B brand should be significantly less than the amount paid by X BV, in the view of the Court.

Court ruling

The Court of Appeal, among others, considered that:

- the taxpayer did not have independent calculations (performed by a third party) available regarding the value

of the brand, which could provide an indication of the value of the brand.

- if value could be attributed to the brand, this value was also created by G and E (being the directors / shareholders of D BV and F BV respectively), as a result of which they would not be willing to pay for the brand.
- in the past no royalty payments were made by the group companies for the use of the brand (which indicated that no value was attributed to the brand).
- the two transactions, being the shares acquisition and the acquisition of the B brand, are closely related and that the allocation of the total price paid for both the shares and the B brand over the shares and the B brand was incorrect.

The Court of Appeal ruled that the taxpayer did not succeed in its burden to substantiate the value of the brand. Subsequently, the Court of Appeal ruled that the B brand had a significant lower value. However, in the view of the Court of Appeal, the brand did have some value since costs to develop a new brand would not have been made by acquiring the B brand. Hence, the Court of Appeal agreed with the Tax Inspector that the depreciation claimed by the Dutch taxpayer on the B brand should be corrected (however not to nil, but to a significant part). Also a penalty was imposed on X BV.

Supreme Court ruling

The Supreme Court ruled that the complaints brought forward by X BV could not lead to cassation of the Court of Appeal ruling. Further motivation was not provided.

Remarks

The decision basically upheld the transfer pricing adjustment of the Dutch Tax Inspector with respect to the value of the acquisition of the B brand (i.e., and the correction on the depreciation on this brand claimed in the 2000 Dutch corporate income tax return).

This case concerned the valuation of a brand that was transferred between associated enterprises. The taxpayer did not have calculations available performed by an independent third party to determine the value of the brand. An important factor in this case is that the burden of proof (that initially rested on the Tax Inspector) was shifted to the taxpayer after the Tax Inspector properly motivated his position in the view of the Court. Further, it is interesting that the two transactions (i.e., the shares acquisition and the purchase of the B brand) were analysed on a combined basis.

Dutch Court ruling addresses transfer price paid by Dutch taxpayer to related Chinese group company⁸

Facts of the case

The X group is engaged in the wholesale distribution of gardening products. The shares in the capital of the Dutch corporate income taxpayer (X BV) are owned by E and F (both Dutch residents) via their Dutch holding companies, respectively for 53 percent and 47 percent. Furthermore, E and F own the shares in the capital of X Ltd (both 50 percent), located in China. The products sold by X BV to customers are mainly sourced from China. X Ltd, employing five employees, conducts quality control for products manufactured in China, logistic control, order tracing, product development and buy-sell activities on behalf of X BV with respect to the tangible products purchased in China. In 2002, X Ltd also made limited sales directly to third parties. The products are directly shipped by suppliers to X BV or directly to its clients. For the fiscal years 2001 and 2002 the profit margins allocated to X Ltd are 10

percent and 14.2 percent respectively over the purchase value of products purchased from Chinese suppliers.

The Tax Inspector takes the position that the transfer prices were not at arm's length. The transfer pricing method applied by the taxpayer results in cost-plus mark-ups of 132 percent (2001) and 275 percent (2002). Considering the functions performed and risks incurred by X Ltd, the Tax Inspector states that the cost-plus methods should be applied, using a profit mark-up of 10 percent (applied to the operating expenses of X Ltd). According to the Tax Inspector no useful Comparable Uncontrolled Prices ("CUPs") were available, since the functionality of X Ltd was not comparable regarding the transactions with X BV (purchasing) and the transactions with independent third parties (also sales function).⁹

Court ruling

The Court agrees with the Tax Inspector that in subject case no useful CUPs were available (without further considerations). Further, the Court ruled that the Tax Inspector made plausible that the transfer prices were not at arm's length, for as far as the transfer prices exceeded the equivalent of a cost-plus using a mark-up of 10 percent (applied to the operating expenses of X Ltd). Subsequently, the taxpayer did not succeed to make plausible that the transfer prices were actually at arm's length.

Remarks

The decision thus upheld the transfer pricing adjustment of the Dutch Tax Inspector with respect to the transfer prices charged by the Chinese sourcing office to the Dutch taxpayer.

This Court case shows the importance of having proper transfer pricing documentation in place to avoid having the burden to prove that the transfer prices are arm's length. Also in this case the burden of proof (that initially rested on the Tax Inspector) was shifted to the taxpayer after the Tax Inspector properly motivated his position in the view of the Court. From the ruling it is not clear whether or not the taxpayer had proper transfer pricing documentation in place for FY 2002. Further, in this ruling the Court refers to the OECD TP Guidelines in determining that the cost plus method is the appropriate transfer pricing method in subject case. An interesting aspect of this case is also that the application of the transfer pricing method for sourcing companies depends on the level of involvement of the sourcing company in sourcing the products. Furthermore, the potentially available CUPs seem to be put aside by the Court rather easily.

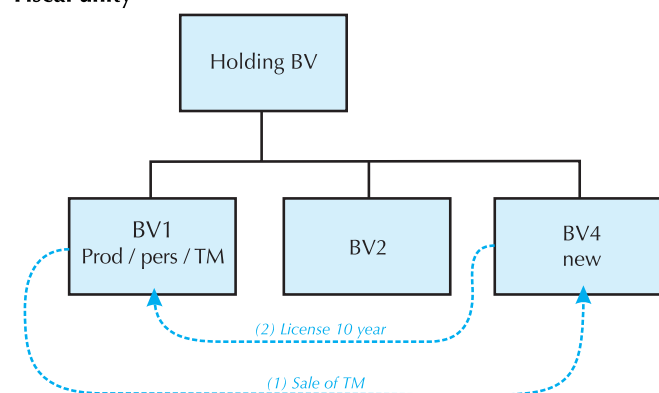
Dutch Court ruling addresses whether licence payments are deductible in a case concerning roundtrip transactions¹⁰

Facts of the case

Holding BV owns the shares in the capital of BV1 and BV2, all included in a fiscal unity for Dutch corporate income tax purposes. Production activities (regarding shoes) and personnel reside under BV1, which company also owns the trade name and trademark. Claiming to protect its trademark, BV1 sells the trademark to BV4 (a company to be incorporated by Holding BV, which will be included in the fiscal unity). Subsequently, BV1 obtains a worldwide exclusive 10 year licence from BV4 for using the trademark, and pays licence fees per shoe sold. BV1 remains owner of the trade name, which sounds the same as the trademark. The simplified structure after incorporation of BV4 can be depicted as shown in Figure 2 above.

Subsequently, the new directors of BV4 reside in the Netherlands Antilles, and the registered office of BV4 is

Figure 2
Fiscal unity



transferred to the Netherlands Antilles. Additionally, BV4 was excluded from the fiscal unity.

The Tax Inspector takes the position that the licence payments and the purchase price of the trademark have not been established based on an arm's length manner. The Tax Inspector also indicates that tax planning plays a role in transferring the trademark to BV4. The Tax Inspector imposes adjustments on the licence payments made by BV1 (fiscal unity) to BV4 for the financial years 1994, 1995, and 1996.

The dispute handled by the Court regarded the questions whether the licence payments paid by BV1 to BV4 are deductible and whether the fact that the amount of the licence payments is depending on the number of shoes sold is in line with the arm's length principle. The level of the purchase price for the transfer of the trademark by BV1 to BV4 was apparently not in dispute anymore. The Tax Inspector stated that the licence payments should be based on an interest percentage applied to the capital invested by BV4 in the trademark (i.e., return on invested capital) and a cost plus mark-up on costs incurred regarding the trademark.

Court ruling

The Court, among others, considered that:

- the taxpayer – to whom the burden of proof was shifted after the Tax Inspector properly motivated his position in the view of the Court – did not succeed in making it plausible that the licence payments have been established on an arm's length basis;
- the taxpayer takes the position that the goal of transferring the trademark is to protect the trademark (if BV1 becomes bankrupt). However, it appears from advice provided by a consultant that a structure consisting of breaking up the trade name and the trade mark will provide the taxpayer with less protection than apparently envisaged. The name can then after all be used by a number of authorised persons which is not in the interest of taxpayer;
- it is implausible that the actual protection of the trademark has been transferred to BV4. In practice, this protection has been executed by a Trade Mark Office and all relevant consultation has taken place between the Trade Mark Office and a contact person of a legal entity (not being BV4);
- it is plausible that BV4 did not play a role as protector of the trademark, but that BV4 was part of a tax saving structure. The Court indicated that taxpayer did not succeed in supporting its position that with inserting BV4 a protection structure was envisaged.

- the arm's length nature of the licensing agreement, and hence the arm's length nature of the resulting licence payments have not become plausible.
- it is implausible that taxpayer actually wanted to sell the trademark, but considered a structure to skim the profits for the benefit of the shareholders plausible.
- For completeness' sake we note that the taxpayer lodged an appeal to the ruling of the Court, which appeal is pending.

Remarks

The decision basically upheld the transfer pricing adjustment by the Dutch Tax Inspector with respect to the licence payments made by the Dutch taxpayer. In subject Court case, no details were described to explain that the burden of proof rested on the taxpayer, which is an important factor in any Court case. The Tax Inspector basically questioned the business motives of the "roundtrip" transactions and argues that tax planning motives have played a role by transferring the trademark to BV4. However, the Tax Inspector does not (completely) disregard the roundtrip transactions. BV4 has become the legal owner of the trademark. The Tax Inspector is basically of the view that BV4 should obtain remuneration for being legal owner of the trademark. The Tax Inspector therefore argues that the licence payments should be based on an interest percentage applied to the capital invested by BV4 in the trademark, which was indirectly calculated to be about 5.35 percent, 6.35 percent and 5.35 percent in 1994, 1995 and 1996 respectively (including the cost plus mark-up).

International developments

Finally, this section summarises international developments affecting the Dutch transfer pricing landscape in the future.

The OECD initiatives continuing in 2007 potentially having an impact on the Dutch field of transfer pricing can be summarised as follows:¹¹

- on December 8, 2006 the OECD released a report entitled "Improving the Resolution of Tax Treaty Disputes". The changes to the Model Tax Convention included in the report were approved on January 30, 2007 by the OECD Committee on Fiscal Affairs (CFA) and will be included in the 2008 update to the OECD Model. Since cross-border tax disputes are expected to become more frequent, the OECD agreed to modify the OECD Model Tax Convention by including the possibility of arbitration in cross-border disputes unresolved for more than two years. Unlike the EU Arbitration Convention, arbitration under the OECD Model is not restricted to transfer pricing issues;
- in May 2007, the World Customs Organisation (WCO) and the OECD held their second joint conference dedicated to transfer pricing and customs valuation in an attempt to foster discussion regarding points of convergence and reconciliation between direct and indirect taxation. "Valuation of Related Party Transactions for Transfer Pricing, Customs and VAT purposes" was the subject of two major conferences jointly organised by the WCO and the OECD in May 2006 and May 2007;
- the European Joint Transfer Pricing Forum (EUJTPF) issued guidelines to avoid transfer pricing disputes in February of 2007. The EU Commission and the EUJTPF consider that APAs are an efficient and appropriate tool to increase legal certainty and to lessen transfer pricing burdens on taxpayers. Therefore the EU Commission drafted guidelines for APAs based on EUJTPF

observations, which are supposed to make it easier for companies to avoid some of the problems caused by different transfer pricing rules and interpretations in the EU Member States. The APA Guidelines have no legal status in the sense that they are enforceable if not adhered to by the EU Member States or taxpayers;¹²

- initiatives are undertaken by the OECD on extending the OECD TP Guidelines with respect to attribution of profits to permanent establishments (in 2007 the Committee has released a revised discussion draft of Part IV which replaces the June 2005 version) and with respect to guidance on business restructuring (see below);
- as part of its procedures for monitoring the implementation of the 1995 OECD TP Guidelines, the OECD Committee on Fiscal Affairs (Working Party No. 6) selected comparability issues (e.g., comparability analysis is essential in applying the arm's length principle, timing issues in comparability, preference for internal comparables, and examining the five comparability factors) and the use of transactional profit based methods (i.e., the transactional net margin methods and the profit split methods) as its priority areas. As regards the status of transactional profit methods, a revision of Chapter III of the OECD TP Guidelines is expected.

In past years, the Committee on Fiscal Affairs created a Working Group to analyse the treaty and transfer pricing aspects of restructuring. In 2007 the OECD pursued its dialogue with the business community on the transfer pricing and treaty aspects of Business Restructurings. The Joint Working Group on Business Restructurings is still at the stage of formulating its policy view on the various issues identified in its mandate. The mandate of the Joint Working Group identifies three broad areas in which work is to be done:

- recognition of transactions presented by a taxpayer. This involves issues as to when a tax administration may disregard or re-characterise specific transactions for transfer pricing purposes, and as to the acceptability and transfer pricing consequences of risk stripping and transfers of intangibles.
- transfer pricing consequences of restructurings that are not subject to re-characterisation. Issues covered are whether, according to the arm's length principle, there should be an indemnification or any other form of compensation upon a conversion; how to determine an arm's length remuneration for the restructured entity and for the principal; whether the arm's length principle applies differently to a restructured activity and to an activity that is set up as "low risk, low intangible, low added value" from the beginning; and whether and how to account for group synergies and efficiency gains in the context of a restructuring.
- permanent establishment issues. Questions for the Working Group to consider include when a foreign enterprise can be found to have a permanent establishment further to a business restructuring, and whether further guidance is needed on the attribution of profits to a dependent agent permanent establishment.¹³

As soon as the OECD has a discussion draft ready (currently projected for late 2008), the draft will be released to the public for comment.

Conclusion

It can be concluded that the field of transfer pricing further developed in the Netherlands in 2007. Although the 2007 APA numbers are not yet available, a comparison between the 2005 and 2006 numbers shows that the APA requests dealt with and sustained by the Dutch tax authorities both increased, while the average process time of requests decreased. In 2007 Ernst & Young commissioned Consensus Research International to conduct independent interviews with 850 MNEs across 24 countries, one of them being the Netherlands. The 2007 Survey results show that Netherlands-headquartered companies are the most vulnerable to transfer pricing audits, with 84 percent having experienced an examination since 2003 somewhere in the world. The Dutch Tax Authorities are in particular focused on the alignment between functions performed and risks assumed and resulting remuneration. Furthermore, three transfer pricing (related) Court cases were published in 2007, for which it is interesting to note that in all cases the burden of proof initially rested on the Tax Inspector, was subsequently shifted to the Dutch taxpayer (since the Tax Inspector made a plausible case) and that the Tax Inspector won in all cases. Also various ongoing international transfer pricing initiatives were continued in 2007.

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- 1 No. IFZ2001/295M
- 2 No. IFZ2004/680M
- 3 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 1995 and subsequently updated.
- 4 BNA International, *Tax Planning International Transfer Pricing*, Vol.8, No.1, January 2007, "Transfer Pricing Developments in the Netherlands".
- 5 Source: Beheersverslag 2005 and 2006 published by the Dutch Ministry of Finance on www.minfin.nl. Merely quantitative information is published.
- 6 2007 – 2008 Global Transfer Pricing Survey: Global Transfer Pricing Trends, Practices and Analyses, December 2007.
- 7 Supreme Court, February 9, 2007, nr. 43.240
- 8 Court of Arnhem, MK, March 7, 2007, nr. AWB 06/288
- 9 For completeness' sake we note that in a separate case the Court ruled that the activities by X Ltd were actually performed in China, and that no Dutch corporate income tax assessment could be imposed on X Ltd as a Dutch resident company.
- 10 Court of Breda, MK, March 26, 2007, nr. AWB 05/1352
- 11 Source: www.oecd.org/taxation/transfer-pricing
- 12 We also refer to M. van Herksen, BNA International, *Tax Planning International Transfer Pricing*, Vol.8, No. 5, May 2007, "There's an APA in your future!"
- 13 Source: www.oecd.org/taxation/transfer-pricing

Developments in the U.K.

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Transfer pricing continued to be a hot topic in the international tax arena in the U.K. in 2007. The key developments were the publication of two Consultation Documents. In June Her Majesty's Revenue and Customs (HMRC) produced a Consultation Document on its proposed approach to transfer pricing for large businesses, in which it addressed many of the long standing concerns that taxpayers and their advisers have expressed around the operation of transfer pricing rules in the U.K. We also received the long-awaited Consultation Document on the taxation of foreign profits. With regard to transfer pricing there were some interesting points here relating to attributing profit to embedded intellectual property (IP) in goods, on which there is more below.

In 2007, we also noted an increase in transfer pricing enquiries in the U.K.; transfer pricing defence and dispute resolution is becoming a major focus of work for advisors. On the European front the Common Consolidated Corporate Tax Base (CCCTB) is also moving forward; the European Commission aims to finalise the approach in September 2008. The majority of Europeans appear to welcome this option, though here in the U.K., as expected, we are more cautious in our approach. Again on the European front, the European

Union Joint Transfer Pricing Forum (EU JTPF) is continuing to seek practical solutions to transfer pricing problems. In 2007 the EU JTPF has been seeking feedback on the Arbitration Convention, which, broadly speaking, U.K. companies are reticent to use, due to its novelty, concern about the advisors' fees involved, and a general desire to avoid starting an even larger transfer pricing enquiry into their affairs.

There follows a more detailed analysis of all these key areas plus some forecasting on what 2008 might bring.

A new HMRC approach to large business

In June 2007 HMRC produced a consultation document on its proposed approach to transfer pricing for large businesses. HMRC also sought opinions on its future approach to addressing the concerns expressed as part of its 2006 "Review of Links with Large Business" – which is more commonly known as the Varney Review.

HMRC's approach can be summarised as follows:

- HMRC are aware that businesses want to achieve greater and earlier certainty and are concerned about the cost of complying with transfer pricing rules;

- the new approach will involve greater specialisation and team work on transfer pricing, engagement with companies that want a pre-return risk assessment, a focus on issues of higher risk, action plans for enquiries agreed where possible with companies, and active monitoring of progress;
- information will be published on the number of transfer pricing enquiries open and the time taken to resolve closed ones; and
- in the international community, HMRC will advocate the wider adoption of the principles of its new approach to transfer pricing.

At Grant Thornton UK LLP we are broadly supportive of much of the content of the consultation. We consider that the risk assessment along with proposals to keep enquiries progressing is a welcome move towards managing many groups' compliance costs in relation to transfer pricing. It is worth noting, however, that the key issues that face our clients in respect of transfer pricing do not just relate to the volume of information requested or the progress of enquiries, but include:

- information requests that are both unfocused and hugely disruptive to the taxpayer being asked to gather the volume of information required;
- HMRC not reading information submitted to it either during the enquiry or as part of prior years' enquiries;
- HMRC contradicting clients' documented and supported transfer pricing positions, including benchmarking work, without offering alternative evidence;
- inspectors with insufficient commercial knowledge of doing business in many developing markets, notably, China, India and Africa; and
- inspectors with insufficient knowledge of normal commercial relationships in individual industries.

We consider that many of these issues can be addressed by HMRC bringing to bear more transfer pricing specialist input earlier on in enquiries, clear project management of enquiries and promoting a non-combative attitude to obtain a speedier outcome. The references to these issues in the consultation document are particularly welcomed and we note that HMRC have just launched a major recruitment campaign to attract transfer pricing economists (though in such a tight market for transfer pricing specialists we wonder how much success it will have).

Taxation of foreign profits

Also in June 2007 we received the long-awaited Consultation Document on the taxation of foreign profits. The document recognises that it is crucial that reform "meets the needs of both business and Government". This included a proposed radical overhaul of the existing Controlled Foreign Company regime with a new Controlled Companies (CC) series of rules.

One of the perceived issues that the proposed CC regime appears to seek to address relates to transfer pricing and to specific reliefs for reorganisations. At Grant Thornton we believe that if the Government does wish to address such issues, it should do so within the framework of the existing legislation rather than imposing new and onerous requirements via a CC regime.

IP is the key area with regard to transfer pricing in this document. The Consultation Document suggests that where controlled companies (at home and in other jurisdictions) earn income from intangible assets which are embedded in products, then

that element of income should be calculated and treated differently for U.K. tax purposes. While this could generate a great deal of work for transfer pricing specialists, it appears to be an unnecessary burden on business. In particular:

- where intellectual property is transferred to a foreign entity in a taxable transaction, there would appear to be no substantive "mischief" provided the price used is an arm's length one. This is an issue for the transfer pricing regime and not for a new CC regime; and
- where existing IP remains in the U.K. and is used by a related party, we believe that this is entirely a matter for the existing transfer pricing regime and should not be brought within ambit of the CC regime.

Trends in U.K. transfer pricing enquiries

In the U.K., transfer pricing defence and dispute resolution has become a major focus of work for advisers, along with transactional work such as due diligence and advance thin capitalisation agreements. Preparing and updating transfer pricing documentation for compliance purposes is still a requirement for larger taxpayers but by no means where they focus their assistance from advisors. Partly this follows from the growth of in-house transfer pricing capabilities, but it also reflects the growing appreciation of transfer pricing risks and risk management possibilities especially in the corporate finance community. Perhaps the reduced interest in transfer pricing planning is another consequence of this appreciation.

Within the growth in the number of transfer pricing enquiries, which issues are now the focus of HMRC challenge? It is possible to highlight the following:

- high profit mark-ups charged by Indian service companies (up to 50 percent);
- significant share of profits being reported by Hong Kong co-ordination centres or sub-licence companies responsible for Chinese manufacturing subsidiaries or contractors;
- low ongoing margins (less than one percent) in some industries;
- the absence of interest charges to exploration subsidiaries in higher-risk jurisdictions; and
- high gearing of subsidiaries as a result of certain transactions.

These issues have one thing in common, namely the atypical economics of certain business models or industries. Bringing this economics expertise to bear is becoming more pressing for all the parties concerned in transfer pricing as taxpayers locate further operations in other jurisdictions.

CCCTB

The European Commission's emerging proposal around the CCCTB proposal is that the profits of businesses operating in more than one EU Member State should be calculated according to a single EU-wide formula, rather than the 27 different views on transfer pricing currently taken by Member States. Profits would then be reallocated to the countries in which the businesses are active, to be taxed at those countries' tax rates. Of course, that would not remove the need for conventional transfer pricing analysis and documentation with non-Member States or even within the CCCTB group with companies which are not majority controlled. However, it would provide the benefit of the offsetting of profits and losses prior to the split of profits across Member States.

According to a 2007 study carried out by KPMG on behalf of the European Commission, tax professionals in Europe's largest businesses are heavily in favour of proposals for a harmonised, pan-European corporate tax system. Businesses are seemingly attracted by the prospect of more straightforward tax compliance and more certainty on the post-tax implications commercial decisions.. The idea was supported by 78 percent of respondents across Europe. Among the large economies, the U.K., was most sceptical, with 62 percent in favour and 32 percent against.

The Commission has stressed that it is not proposing a single European corporate tax rate. But 69 percent of respondents said that in addition to the common corporate tax base they would like to see a single rate for the whole of Europe. The U.K. was one of only five countries which recorded business majorities against a single rate. HMRC is also less convinced than many others on the whole question of CCCTB.

Common transfer pricing documentation

In 2006 the Council of the European Union and the representatives of the governments of the Member States agreed on a Code of Conduct on Transfer Pricing Documentation (EU TPD) for associated enterprises in the EU.

In the U.K. we note that inspectors are increasingly prepared to move away from their insistence on U.K. specific benchmarking to accept the results of pan-European research because of the introduction of the Code of Conduct. They have been open to documentation prepared according to the EU TPD format, which is line with a welcome flexibility by HMRC in respect of documentation format and pricing methods.

However, in our experience, most of our U.K. clients have not formally adopted the EU TPD approach because it was designed as a *ceiling* on the information that Member States should require and some international taxpayers are used to preparing less documentation. However, a number of groups, typically US parented, do prepare one central file, the relevant parts of which can be made available to local tax authorities as appropriate.

Arbitration

In 2007 the EU JTPF carried out a survey of the effectiveness of the European Arbitration Convention (AC). At Grant Thornton we found that our clients in the U.K. are reticent to use the AC for a number of reasons including:

- the perceived cost of going to AC – clients that are dealing with relatively small potential adjustments are unwilling to commit the business to the ongoing and potentially substantial advisers' fees and distraction to management time, in order to use the AC procedure
- reputational risk – clients are unwilling to have their particular cases known in the public arena in any way lest it damage the reputation of the business. Furthermore, companies are keen that competitors know little of their activities or challenges facing them with tax authorities
- the perception that the AC procedure is for large companies and that their case will not warrant the procedure because it is not complex enough or the absolute amounts of tax at stake are too small (even though they may be material to the business itself)
- a desire to avoid starting an even larger transfer pricing enquiry into their affairs, maybe on a multinational scale
- the local tax inspector is typically unwilling to take the matter to arbitration as this would necessitate seeking

approval at the highest level in the tax authority and demand a detailed level of analysis which the inspector would prefer to avoid. More than one U.K. inspector has offered a deal on condition that our client does not involve another tax authority.

Business restructuring

During 2007 the OECD Committee on Fiscal Affairs has explored the issue of exit taxes levied on businesses which restructure to the detriment of local profits (one of the authors works closely with BIAC (the Business Advisory Committee to the OECD) on this project). U.K. corporate taxpayers have been dismayed at the aggressive new German approach on this issue but they have experience of other tax authorities ignoring the reality of a restructuring and continuing to assess taxes on the basis of the old level of earnings, for example. We have generally been able to reach agreement on the tax implications of such restructurings with HMRC.

Conclusions

Clearly, the key U.K. development in 2007 has been the publication of the two Consultation Documents. On the taxation of foreign profits, a detailed Consultation Document is expected to be released around Budget time in the Spring. On the approach to transfer pricing for large business, HMRC announced at the end of December 2007 that it had adopted the draft guidance and would publish statistics in April 2008 on the time taken to resolve transfer pricing enquiries in the first three months of the year. Longer term, the move away from a focus on documentation and into defence and transaction-driven transfer pricing means that advisers will need to bring practical solutions to the table quickly if they are to continue to add value.

What are the U.K. transfer pricing challenges for 2008? Certainly these issues should be on any shortlist:

- advising companies on the implications for them of the new HMRC approach to transfer pricing for large business and the transfer pricing implications of the new HMRC approach to the taxation of foreign profits
- continuing to guide companies on the merits and application of the European Common Documentation format
- explaining to auditors and in-house finance staff that, as a minimum, a process should be put in place to gather the relevant information and calculate the profits of potential permanent establishments along the lines of the OECD's working document (a revised Article 7 of the Model Treaty should be published in 2008)
- keeping companies up to date with the OECD's review of the tax treatment of business restructurings (from which there should be a discussion draft by the end of 2008)
- helping companies to decide whether they would wish to opt in to a CCCTB approach to European profit reporting.

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U.S. review: enforcement and certainty

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The year 2007 saw a continuation of the two transfer pricing themes that have been dominant over the last several years: increasing enforcement efforts and the desire for transfer pricing certainty. The increased enforcement theme stems from the U.S. government's continuing belief that transfer pricing allows some taxpayers to inappropriately shift income outside the U.S. taxing jurisdiction. The desire for certainty is a direct response to increased enforcement efforts, which have increased the potential for uncertainty and disputes with the Internal Revenue Service.

This article summarises the developments during 2007 in light of these themes.

U.S. Treasury study

The U.S. Treasury Department on November 27 released to Congress a report on earnings stripping, transfer pricing, and U.S. income tax treaties. The transfer pricing section of the report, which was mandated by sections 424 and 806 of the American Jobs Creation Act of 2004, describes the study undertaken by Treasury regarding the effectiveness of the current transfer pricing rules and compliance efforts in ensuring that cross-border transfers and other related-party transactions cannot be used improperly to shift income out of the United States.

The transfer pricing portion of the report follows two prior reports, issued in 1999 and 2001, and describes:

1. the background on transfer pricing compliance under the current regulatory regime, including major examination initiatives recently undertaken by the IRS;
2. progress made in developing and administering the transfer pricing rules since 1986; and
3. potential shortcomings of the current regulatory regime from a legal/administrative and empirical basis.

The report's main conclusions regarding transfer pricing include the following:

- there remains some potential for income shifting from non-arm's-length transfer pricing, specifically in relation to cost sharing arrangements;
- top priority should be given to the prompt finalisation of the proposed global dealing regulations, the proposed cost sharing regulations, and the temporary and proposed services regulations;
- additional disclosure requirements for taxpayers are not recommended at this time, because of the burden companies already face in complying with the transfer pricing rules; and
- existing transfer pricing rules and compliance efforts must be continually monitored to ensure their effectiveness.

IRS transfer pricing enforcement developments

Given the failure to finalise three significant sets of regulations (intercompany services, cost sharing, and global dealing) some may consider the IRS's and Treasury's enforcement efforts in 2007 disappointing. However, this disappointment ignores significant progress made in other enforcement areas. In particular, the IRS continued to make transfer pricing a top enforcement priority and provide timely guidance to its field exam teams.

IRS tiered audit system

On March 9, the IRS released its Industry Issue Focus (IIF) approach to categorising issues into tiers according to compliance risk and listed several transfer pricing issues as posing a high or significant risk of non-compliance across industries. Under the IIF approach, issues are categorised in the following tiers:

- **Tier I:** The IRS considers these issues to have the greatest compliance risk, and they have "high strategic importance." Field personnel will be required to implement guidance recommendations without discretion for the facts and circumstances of an individual case. Transfer-pricing-specific issues within Tier I include (i) section 936 exit strategies and (ii) cost sharing activities involving offshore transfers of intangibles.
- **Tier II:** The IRS also considers these issues to entail a high risk of non-compliance, but will permit field personnel to use their discretion in applying guidance recommendations to individual cases. Cost sharing related to stock-based compensation and milestone or royalty payments in the biotechnology and pharmaceutical industries are transfer pricing issues classified as Tier II issues.
- **Tier III:** This tier will include issues affecting fewer taxpayers than Tier I or Tier II issues (e.g., confined to one industry category). The IRS has not yet published a list of Tier III issues.

Under the IIF approach, IRS cross-functional teams, including IRS technical advisers, IRS Office of Chief Counsel officials, the IRS Appeals unit, and industry counsel will develop guidance for IRS field personnel. This guidance may take many forms, including technical advice, general legal advice aimed at commenting on a specific tax issue, or even designating certain issues for litigation. Some guidance will be publicly available and others will be internal to the IRS. During 2007, the IRS released guidance on each of the Tier I transfer pricing issues.

Section 936 exit strategies

The IRS has published audit guidelines on auditing section 936 exit strategies. Prior to its expiration for tax years beginning after December 31, 2005, section 936 offered a credit against U.S. taxes imposed on income earned by a U.S. corporation that conducted a trade or business in Puerto Rico. With the

section 936 phaseout, many taxpayers are reincorporating the tangible assets of their Puerto Rican operations as a branch of a controlled foreign corporation, and then licensing the use of intangible assets to the new CFC.

Because section 936 exit strategies are a Tier I IIF issue, the published guidelines are nondiscretionary to field teams. The guidelines direct the audit team to fully evaluate the functions and risks highlighted by taxpayers, and to determine an appropriate arm's length return. Among the factors the guidelines highlight for agents are: unreasonable operating margins for the new CFC, insufficient U.S. profits to fund ongoing research and development to provide future intangibles to the CFC, and significant U.S. operating costs relative to the amount of residual profit.

Cost-sharing of offshore intangible transfers

The second Tier I issue relating to transfer pricing relates to cost sharing activities involving the offshore transfer of intangible property. This was an area of focus for the IRS during 2007, culminating in the issuance of a Co-ordinated Issues Paper (CIP) on Buy-In payments in September (see below).¹ In advance of the CIP, the IRS issued additional guidance relating to intangible transfers. The IRS stated that not only may a taxpayer not invoke section 482 if the Service has not proposed an adjustment, but taxpayers may not apply the commensurate-with-income provision to challenge a section 482 adjustment if the IRS did not apply the commensurate-with-income provision as the basis for the adjustment.²

Cost sharing co-ordinated issue paper

On September 27, the IRS issued a CIP on "Section 482 CSA Buy-In Adjustments".³ The purpose of the CIP is to provide guidance to IRS personnel concerning methods that may be applied to evaluate the arm's length "buy-in" payment charged as part of a qualified cost sharing arrangement (CSA). The CIP addresses two buy-in scenarios: an "initial buy-in" and a "subsequent acquisition buy-in". Under an initial buy-in scenario, a U.S. consolidated group makes a self-developed buy-in intangible available to a CSA at the time the participants, the U.S. group, and its controlled foreign corporation (CFC) originally entered into the agreement. Under a subsequent acquisition buy-in scenario, the buy-in intangible is acquired in an asset or stock acquisition by the U.S. group from an uncontrolled taxpayer and made available to an ongoing CSA.

The CIP incorporated many of the concepts discussed in the 2005 proposed cost sharing regulations, and consequently, was criticised by taxpayers and transfer pricing practitioners for being based on unrealistic assumptions and for the appearance of being drafted to maximise the amount of the cost sharing buy-in payment.

The "best method rule" is a guiding principle of the U.S. transfer pricing regulations, whereby "The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result".⁴ There is no strict priority of methods, and no method is considered invariably more reliable than any other methods. Nevertheless, the CIP argues that two "unspecified" transfer pricing methods ("unspecified" because they are not discussed in the existing U.S. transfer pricing regulations) are generally the best methods

– the income method for initial buy-ins and the acquisition price method for subsequent acquisition buy-ins.

In general, the IRS believes that many of the buy-in quantification methods taxpayers have historically employed substantially underestimate the economic value of the rights transferred out of the United States in return for the buy-in payment. Thus, the CIP articulates many of the same IRS concerns that are reflected in the proposed cost sharing regulations that were issued in August 2005. Those regulations exist only in proposed form and therefore are not in effect. The CIP states that the positions it presents are based on the existing U.S. transfer pricing regulations and, in particular, on an application of the best method rule.

Rejection of common taxpayer arguments

Before describing the income and subsequent acquisition price methods, the CIP presents the "shortcomings" of what it describes as typical taxpayer arguments under the factual scenarios presented. The positions discussed are with respect to the following issues:

- identification and categorisation of intangibles;
- the scope of buy-in intangible rights;
- transactions claimed as CUTs are not truly comparable;
- rejection of the residual profit split method;
- the appropriate treatment of goodwill and going concern value;
- the commensurate with income standard; and
- attributing substantial positive net present value to the CFC's projected research.

Initial buy-in best method analysis

According to the CIP, the income method is generally the best method for determining the initial buy-in, even though it is not a specified method under the existing U.S. transfer pricing regulations. The income method determines the value of the buy-in intangibles as the present discounted value of the stream of projected operating profits of the CFC, after reduction for routine returns and projected cost sharing payments for the CFC's share of the R&D costs projected under the CSA. Thus, the income method is similar to a traditional business valuation discounted cash flow analysis, except that the initial basis of the valuation is operating profits, rather than free cash flows.

The market capitalisation method is offered as a second unspecified method that may be used to evaluate an initial buy-in. This method may be used either by itself or as a corroborating method. The method assumes that the U.S. parent of the U.S. group is a publicly traded corporation. Application of the method requires three steps. First, the total value of all intangibles of the U.S. group is estimated as the difference between the market capitalisation of the U.S. parent's stock, plus the value of corporate liabilities, and minus the value of the tangible property of the U.S. group. Second, the step one intangible value must be reduced by the value of the U.S. group's operating intangibles other than the rights transferred in the buy-in intangible. The third and final step determines the initial buy-in amount as the CFC's pro rata share of the amount calculated under step 2. The CFC's pro rata share for this purpose is its reasonably anticipated benefit share.

Subsequent acquisition buy-in best method analysis

According to the CIP, the acquisition price method is an unspecified method that generally provides the best method for determining a subsequent acquisition buy-in. The method determines the value of the buy-in intangible by reference to the acquisition price. Like the market capitalisation method, the acquisition price method requires three steps. The first step is to determine the total value of all the acquired intangibles. In an asset acquisition, this is the acquisition price of the target's assets minus the value of the target's tangible property. In a stock acquisition, this is the acquisition price of the target's stock, plus its corporate liabilities, minus the value of the target's tangible property. The second step is to reduce the step one value by the value of acquired operating intangibles (if any) that are not transferred or made available to the CFC. The final step is to set the subsequent acquisition value as the CFC's pro rata share of the step two buy-in intangible amount, where the pro rata share is based on the CFC's reasonably anticipated benefits.

Impact of FIN 48

Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48) became effective for public companies for years beginning after December 15, 2006. FIN 48 requires companies to separately identify their uncertain tax positions (UTPs) and to make two determinations. First, a company with UTPs is required to determine whether the position is "more likely than not" to be sustained on its technical merits alone. If not, no tax benefit may be recorded with respect to that position. If so, the company must apply a probabilistic measurement standard to determine the greatest amount of tax benefit that is more than 50 percent likely to be realised upon effective settlement. In addition to the substantive transfer pricing issues, FIN 48 has raised several procedural issues for taxpayers.

Tax accrual workpapers (TAW)

Historically, the IRS has followed a "policy of restraint" with respect to TAWs under which the IRS will request TAW only under "unusual circumstances", unless the issue under examination relates to a Listed Transaction (that is, a transaction the IRS considers potentially abusive).⁵ Taxpayers have expressed concerns that the tax accrual workpapers produced by auditors as part of their FIN 48 analyses could serve as a "roadmap" upon IRS audit. Those concerns were fuelled in part by the IRS LMSB Memo Updating Tax Accrual Work Paper Policy Following FIN 48,⁶ which stated that it was re-evaluating its TAW policy "to ensure that it is still appropriate in today's environment". Despite those concerns, the IRS continues to follow the existing IRM policy guidelines calling for restraint.

Taxpayers also received some support from the *Textron* case, whereby the Federal District Court held that the disclosure of TAW to an independent auditor did not result in the waiver of work product privilege.⁷

Memorandum to IRS examiners on FIN 48

On June 26, the IRS released a memo entitled *IRS LMSB Memorandum to Examiners on FIN 48*.⁸ The memorandum was issued to educate its field exam teams and contains a summary of FIN 48 and a list of frequently asked questions (FAQs).

The answer to a FAQ confirmed that FIN 48 workpapers are TAW and therefore subject to the IRS policy of restraint. However, it went on to state that FIN 48 disclosures in quarterly or annual financial statements or in any other public documents are not subject to the policy of restraint, and should be considered by examiners and other IRS personnel when conducting risk assessments.

Another FAQ asks whether the IRS would reopen an examination that had been previously closed as the result of a FIN 48 financial statement disclosure. The response states that it has been the IRS's long-standing policy not to reopen tax years that have been examined and closed, but under exceptional circumstances that may occur. The response goes on to state that although the Service has no plans to change that policy, the additional disclosures required by FIN 48 may result in this happening more frequently within the existing policy, because of the increased availability of information that could warrant reopening.

Lastly, another FAQ addresses a number of ways in which the IRS "can help taxpayers gain certainty more quickly in regard to their FIN 48 unrecognised tax benefits". The response lists 10 IRS programmes and processes that can be used for this purpose, including advance pricing agreements.

Co-ordination with customs valuations

During 2007 there was also an increased focus on finding a way to improve consistency and increase certainty between transfer pricing and customs valuation. However, in an April 2007 document titled *Determining the Acceptability of Transaction Value for Related Party Transactions*, the U.S. Customs and Border Protection (CBP) noted that an APA or a transfer pricing study by itself is not sufficient to show that a related-party transaction value may be used for customs purposes. Previous CBP rulings are further evidence to this point, as the CBP concluded that an APA or transfer pricing study was not enough to show that a company met specific customs documentation requirements.

The CBP document also underscores the differences in the pricing methods used for customs and income tax purposes. For customs purposes, each imported article requires an individual valuation. In contrast, section 482 regulations under the U.S. Internal Revenue Code permit a transfer pricing analysis to aggregate intercompany transactions and offset adjustments when the situation allows. The comparable profits method (CPM) under the section 482 regulations, a profits-based method and typically the most commonly used method for transfer pricing analysis, has come under the greatest scrutiny by customs officials. According to the CBP, the CPM as compared to other specified transfer pricing methods "generally has the least relevance for customs purposes". The methods for customs valuation require evaluations relating to comparable products or goods, whereas the CPM relies less on product similarity and more on the taxpayer's profitability against that of other comparable companies performing similar functions and incurring similar risks. Given these facts and circumstances, the CBP prefers the use of the comparable uncontrolled price (CUP) method in the section 482 regulations for customs valuation purposes, because it analyses transactions with uncontrolled parties in which the circumstances, including the products or goods, must be considerably similar.

Foreign-to-foreign transactions

In CCA 2007-29-034, the IRS addressed the issue of whether certain transactions were not subject to the net adjustment penalty under I.R.C. section 6662(e)(1)(B)(ii) on the basis that the transactions qualified, at least in part, for the foreign-to-foreign exclusion under I.R.C. section 6662(e)(3)(B)(iii). The U.S. taxpayer (UST) had, through direct and indirect interests, 100 percent of the ownership interest in a U.S. partnership (USP). USP purchased finished products from ForCorp (FC), a wholly owned subsidiary of UST, for the purpose of distributing such products through its global distribution network. FC had obtained these finished products from its own foreign subsidiaries (FSS), which manufactured and sold these products to FC.

In determining the section 482 adjustment, the IRS applied an aggregation approach and treated FC and FSS as a combined entity ("Foreign Group") for testing purposes⁹ and asserted a section 482 adjustment and net adjustment penalty. The IRS asserted that the taxpayer's application of the CPM allowed shifting of income from USP to Foreign Group, in part because the prices paid by FC to FSS (and reflected in FC's cost of goods sold) were not in accordance with the arm's length standard. In contesting the penalty, the taxpayer asserted that the net section 482 adjustment consisted of two distinct adjustments:

1. an adjustment to the transactions between USP and FC; and
2. an adjustment to the transactions between FC and FSS.

The IRS rejected the notion that because the price of products sold from FSS to FC was incorporated into the price of products sold by FC to USP in the application of the CPM, some portion of the section 482 adjustment qualified for the foreign-to-foreign exclusion. The IRS concluded that the transaction under review was between USP and FC, which did not qualify for the foreign-to-foreign exclusion. The fact that the price of products sold from FSS to FC was relevant in applying the CPM to test the transactions between FC and USP had no relevance in determining whether the foreign-to-foreign exclusion applied. The IRS noted that if the CUP method applied to FC's sale of products to USP, the prices paid by FC to FSS would be irrelevant altogether, and concluded that the foreign-to-foreign exclusion was not dependent on the "application of one specified method as opposed to another".

Advance pricing agreements

Notable 2007 APAs

APAs were a major topic of discussion and interest in 2007, particularly in response to the IRS's increased enforcement focus. The United States and the People's Republic of China announced, on January 12, 2007, the completion of a bilateral advance pricing agreement, the first between the two countries. The APA involved Wal-Mart Stores Inc. (Wal-Mart), the world's largest retailer, which currently employs more than 42,000 associates in China. Prior to the agreement with the United States, China had previously reached a similar agreement only with Japan (in May 2005) and is currently in negotiations on a bilateral agreement with the Republic of Korea.

In a statement on the Wal-Mart APA, the Chinese State Administration of Taxation said that the agreement made it

possible for tax departments and the Arkansas-based retailer to resolve transfer pricing issues before they arose during an audit. According to all parties involved in the negotiation process, including Wal-Mart, this bilateral agreement has helped advance taxation co-operation between the two countries and will benefit future bilateral APAs between China and the United States.

The other APA of note in 2007 involved Google Inc. On February 1, 2007, Google announced that it had concluded an APA with the IRS in December 2006. The APA applies to taxation years beginning in 2003. As a result of the APA, Google was able to reduce some of its income tax contingency reserves and recognised an income tax benefit of approximately \$90 million.

The Google APA, as well as the historic Wal-Mart agreement, highlights the monetary and administrative benefits that can result from an APA, and will most likely elicit discussions within the tax departments of many U.S. corporations. The completion of such agreements can assist in reducing the risks of potential double taxation that can arise from conducting operations globally.

APA programme annual report for calendar year 2006

On February 26, 2007, the IRS Advance Pricing Agreement Programme issued its eighth annual report¹⁰ describing the operation of the programme for calendar year 2006. We expect the IRS to issue its annual report covering calendar year 2007 sometime in late February or March of 2008.

The 2006 annual report provides operational transparency and allows taxpayers to better gauge what negotiating an APA will entail. Below are some highlights of the statistics contained in the annual report:

- the IRS completed 82 APAs in 2006, and a total of 692 APAs since the APA Programme's inception.¹¹ For 2006, unilateral APAs represented 51 percent of the cases and bilateral/multilateral cases 49 percent of the cases. However, bilateral cases constitute approximately 82 percent of the inventory of pending cases.
- the median number of months to complete a new bilateral APA is 45.4 months, and for a new unilateral APA it is 22.9 months.¹² On average, renewal APAs take approximately six months less to complete than new APAs.
- inbound cases (foreign parent with U.S. subsidiaries or branches) represent approximately 54 percent and outbound (U.S. parent with foreign subsidiaries) cases represent approximately 46 percent of the cases completed in 2006.¹³
- the most common functions performed by the APA's tested party were distribution, marketing, and manufacturing.¹⁴
- the most common transfer pricing method (TPM) for transfers of tangible and intangible property is the CPM using the operating margin as the profit level indicator (PLI).¹⁵ The second most common TPM for transfers of tangible and intangible property is the residual profit split method.¹⁶ The most common TPM for services transactions was the CPM using the mark-up on total costs as the PLI.¹⁷
- despite the transfer pricing regulations under Internal Revenue Code section 482 requiring the IRS to make

adjustments to the median of the arm's length range, less than 20 percent of APA TPMs required adjustment to the median.¹⁸

- the most common APA term is five years (56 percent); however, longer terms were agreed to in 32 percent of the completed APAs.¹⁹
- approximately 32 percent of completed new APAs included rolling back the APA TPM to open tax years preceding the APA term. Approximately, one-third of these rollback cases were for five or more years.²⁰

Conclusion

2007 proved to be an eventful year in U.S. transfer pricing. While the much anticipated regulations (services, cost sharing, and global dealing) were delayed to 2008, many developments related to enforcement activities and the use of the APA programme to obtain transfer pricing certainty kept taxpayers and transfer pricing practitioners busy.

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1 LMSB-04-0907-62

- 2 IRS Advisory Memorandum on the Use of Section 482 and the Commensurate with Income Standard, AM 2007-007, March 15, 2007.
- 3 LMSB-04-0907-62
- 4 Treas. Reg. Section 1.482-1(c).
- 5 IRM 4.10.20.
- 6 LMSB-04-0507-944, dated May 10, 2007.
- 7 *United States v. Textron Inc. and Subsidiaries*, U.S. District Court R.I., 2007-2 USTC ¶150,605 (August 29, 2007).
- 8 LMSB-04-0507-045, dated May 2007.
- 9 See Treas. Reg. Section 1.482-1(f)(2)(i).
- 10 Announcement 2007-31, 2007-12 I.R.B. 769. The IRS APA Annual Report is prepared pursuant to Section 521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999.
- 11 APA Annual Report, Table 1.
- 12 APA Annual Report, Table 2.
- 13 APA Annual Report, Table 13
- 14 APA Annual Report, Table 16.
- 15 The CPM and corresponding profit level indicators are equivalent to the transactional net margin method (TNMM) and corresponding bases under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines). For example, CPM using operating margin is equivalent to the TNMM using revenue as the base.
- 16 APA Annual Report, Table 19.
- 17 APA Annual Report, Table 20.
- 18 APA Annual Report, Table 27.
- 19 APA Annual Report, Table 28.
- 20 APA Annual Report, Tables 1 and 29.

Special Reports

Advance Pricing Agreements

Transfer Pricing can be one of the most vexatious areas of tax planning, with many possible pitfalls, but *Advance Pricing Agreements* provide a method of gaining certainty before transactions are undertaken. All MNEs doing business with related parties should consider whether an APA is the way to ensure that there are no unexpected tax charges or penalties. This Special Report provides detailed information on the APA process in major trading nations, written by experts in the jurisdiction.

Content for each jurisdiction includes:

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- Likely timescale to conclude the APA

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