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Asia Transfer Pricing

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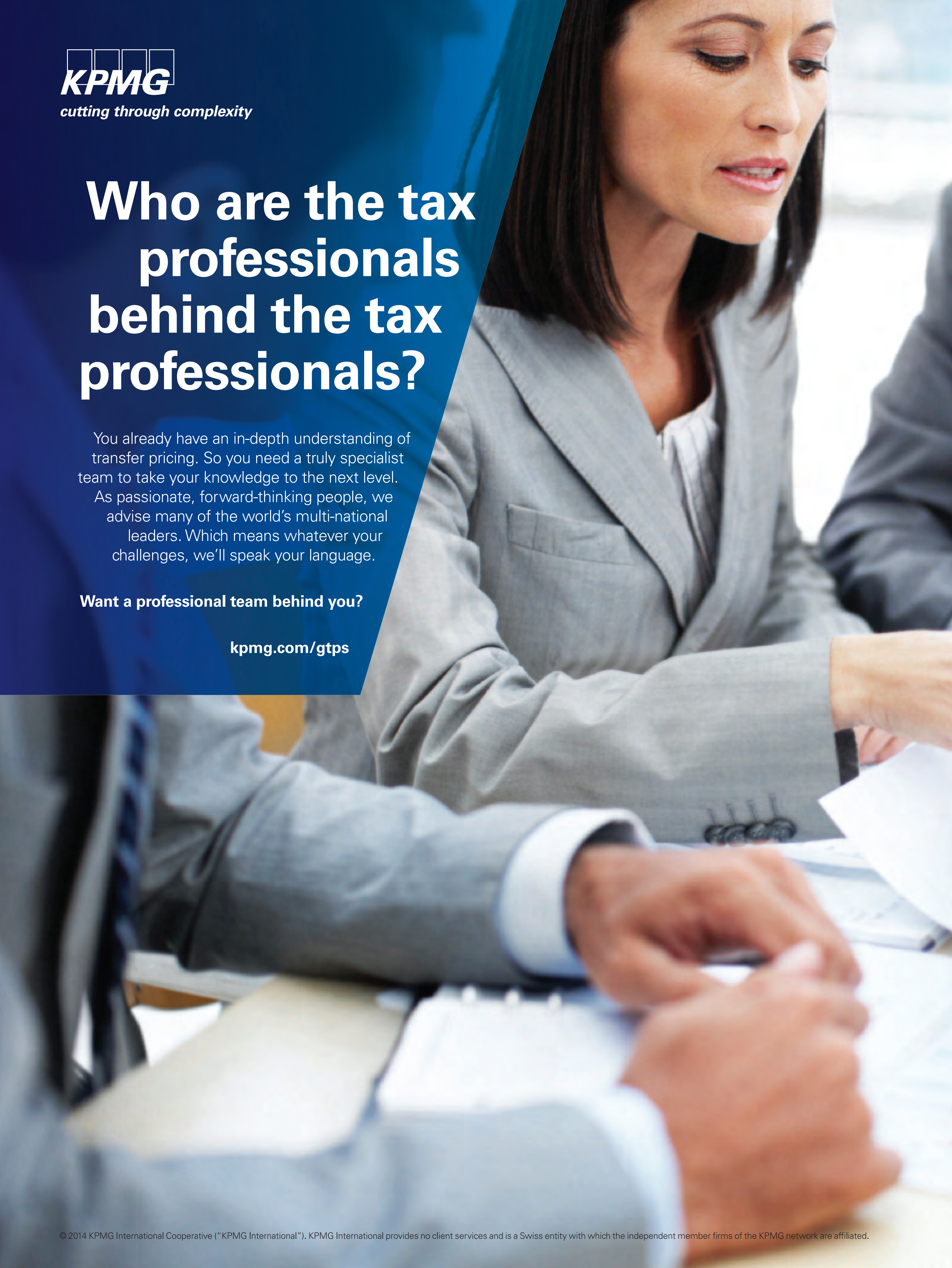
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INTERNATIONAL TAX REVIEW™

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INTERNATIONAL TAX REVIEW

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Editorial


Salman Shaheen

Asia is home to the world's oldest civilisations. It is the cradle of some of the most ancient traditions.

But the pace of change in an ever globalising world is picking up. And while governments and taxpayers have long clung to their traditions in taxation and transfer pricing, they must adapt to a rapidly developing global environment.

Transfer pricing rules as they have been traditionally conceived have failed to answer the questions civil society is raising over base erosion and profit shifting. In short, they are failing to deliver the tax developing countries believe they are entitled to.

As Asian countries increasingly flex their economic might around the world, they will look to cast their tax nets wider and crack down on what they see as abusive practices. They will be more vocal in their demands for the rules to be rewritten and they will be more aggressive in pursuing the revenue they believe is owing to them.

All of this leaves some choppy waters for taxpayers in the Asia-Pacific region to navigate. They must ensure they are up to date on the latest national legislation and international guidelines. They must keep abreast of the latest court cases and the precedents they set. And they must ensure they are vigilant in their compliance to avoid some nasty penalties.

For the seventh time, *International Tax Review* brings you its guide to *Asia Transfer Pricing*.

In these pages, leading transfer pricing advisers from KPMG in Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Taiwan, Thailand and Vietnam bring you insights and advice from across the region.

We hope you find this guide an invaluable tool as you conduct your business in an ever more lucrative region, in ever more interesting times.

Salman Shaheen
Editor
International Tax Review

BEPS and the Silk Road of TP: Will the sick man survive the trip?

Kari Pahlman of KPMG in Hong Kong provides an outlook on BEPS and the dynamics of Asian transfer pricing.

Transfer pricing, like its broader parent the international tax system, is in the emergency room. As the readers surely have noted, the system has been diagnosed to be a sick man to whom the doctors (OECD under the guidance of G20) are now mixing increasing doses of medicine at increasing pace. The BEPS project is making efforts to fix things and create a transfer pricing framework which would better align the outcomes with the true value creation contribution of the various parties and create more transparency and standardisation for transfer pricing documentation (as previous medicine has been too diverse and localised). As the disease is widespread, further measures, such as guidance on financing transactions, are expected on the second stage of the project.

While the big debate on whether arm's-length will survive or be replaced by formulary apportionment has somewhat faded, the medicine mix seems to suggest that this question is still implicitly present. For example, both the latest intangibles draft and the recent country-by-country reporting (CBC) initiative could give tax authoritie potential ammunition for wider application of formulaic profit split methods. And there are abstract statements on how certain difficult areas may have to be resolved by solutions outside of the arm's-length standard.

An absolute key for BEPS initiative will be the ability of jurisdictions to reach a broad enough consensus on the framework to be implemented, resulting ultimately in a level playing field. In this respect, the fact that BEPS is now really a G20 initiative may help to get all major global economies on board and this would in the course of time create pressure for any outliers to also join. However, the G20 aspect will also reinforce the views and demands of the big non-OECD developing countries in this process, potentially making consensus more difficult.

One fundamental challenge is the true level of harmonisation for transfer pricing which realistically can be achieved under any regulatory solution. To remind ourselves, transfer pricing, perhaps more than any other area in tax, is a principles based, inexact science and any level of regulation cannot exhaustively resolve the myriad real life transfer pricing permutations. BEPS may be further compromised in this sense because of the urgency vested to the project by the politicians. Given these inherent limitations, success will heavily depend on what happens to BEPS at national implementation and interpretation level. The big question here is whether the governments would really backtrack from their existing, divergent practices towards a more unified position or whether they would use BEPS just as a means to top up their existing regimes with new obligations and approaches.

Finally, additional challenges to the success arise from the unabashed stance of countries to use fiscal incentives to attract foreign investment. Political and peer pressure is now expected to eliminate the most abusive schemes but jurisdiction to tax will prevail and even in a post-BEPS world, there will be incentivised regimes as long these are based

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Kari works both with global MNEs and new emerging market champion across a wide range of industries ranging from retail and consumer markets, energy and natural resources, financial services, industrial markets, transport and logistics to information, communication and telecoms. As a member of KPMG's global value chain management team, Kari has extensive experience in conducting large scale business transformations and tax value chain management projects across an integrated suite of tax services. He also regularly works on engagements covering discrete transfer pricing planning, global or regional documentation and dispute resolution.

He is a frequent public speaker and regularly publishes in international and regional journals.

on robust substance and transparency. So the schizophrenic behavior, where some countries mix right hand posturing against aggressive tax planning with left hand introduction of tax incentives, will likely not disappear. Analogous to stock market and trader behaviour, whenever the government brain is inflicted with a prospect of future FDI dollars, rationality may break down, compromising any pre-agreed principles on profit and tax allocation. One wonders if governments can really stick to unified, BEPS compatible standards in the future when they compete over the mobile resources of the MNES.

In terms of Asia, transfer pricing has been on a Silk Road between West and East for years and the road has also become a two-way one. BEPS has already built a presence in Asia and is hence nothing new to the region. Obvious examples come from China and India who have for years pursued innovative, less conventional approaches, seeking to account for the true value generation occurring in these countries. Location savings, market premiums and other unique attributes are such attempts to align profits with value creation, however, rather than being about eliminating double non-taxation, they have created a sticky, double taxation prone deadlock between developing and developed economies. These factors are now being codified as comparability factors in the revised OECD intangibles chapter, perhaps partially as a practical solution to provide oxygen to the continuous application of the TNMM and avoid developing country tax authorities converting to profit splits as a default.

Looking at Asia further, one can note that also some of region's most developed countries, such as Australia, are living and breathing BEPS. For years, the Australian Taxation Office (ATO) has placed an increasing emphasis on the transaction characterisation (rather than the mere price), hence going back to the heart of the arm's-length principle. The ATO is now already pursuing unilaterally its own BEPS implementation process which has features akin to CBC. The broader pattern in the developed Asian inbound jurisdictions has been for tax authorities to move, once having taken their battles on local distributor margins, on to push hard against any profit stripping business restructurings and intra-group funding arrangements.

Asian countries are a very diverse mix and in some of them, particularly in South East Asia, transfer pricing developments were momentarily stagnated over the past few years. However, there is now momentum again and the common threads are increasing activity and ramp up of rules, compliance obligations, enforcement and resulting disputes. Financial and trading hubs like Hong Kong and Singapore are also gearing up their actions, as they are now very focused on preserving their fairly recently achieved status as white-listed, transparent jurisdictions with proper transfer pricing regimes.

Across the board, the conventional, problematic transfer pricing issues in Asia continue to be ever present. To name a few, managing self initiated true-ups and related customs issues continues to be very challenging and there are the eternally lasting disputes on service/headquarter charges where taxpayers are expected to present two truckloads of information to evidence the benefits. Many have faced a slow death in the sun in these battles and it seems BEPS may now reinforce this trend, unless action 10 truly manages to strike a balance against the excessive demands of many tax authorities.

So, from a substance standpoint BEPS is and has been, to variable degree, already present in Asia. What we have not really seen in Asia is the media attention and reactions from the public. This is natural given that the region is not undergoing any real austerity and the public in most countries is likely to be focused on more fundamental political issues.

What will one make out of all this? The heading provokes that there is little prospect for the sick man to heal, if not even to survive. BEPS will seek to modernise the transfer pricing system and eliminate some of the loopholes and perceived weaknesses. It is also expected to materially increase transparency and information access, while simplifying the vastly proliferated compliance landscape. But for BEPS to succeed it will have to achieve all these ambitious objectives without generating a framework for increased disputes and double taxation.

While we hope that this future perfect world will materialise, a pinch of realism is necessary. Governments will still always choose the particular transfer pricing strategies and approaches which fit into their proprietary position in the global economy and trade flows. Tax authorities at a practical level will also forever disagree where value is created, at least as soon as the stakes of any case get high enough. Developed countries likely will continue to emphasise brands, technology, capital and strategic management as key value creators whereas developed countries will pursue their anti-colonial transfer pricing, claiming that labour, infrastructure and consumption power are the real sources of value. Modern transfer pricing is a fluid escort, conveniently lending arguments from both capitalist and socialist economic theories and going where the money is. Given all this, the moderated global economic growth levels and the fiscal tightness, it is fair to say that pressure on dispute resolution mechanisms will not fade away.

It is not all doom and gloom though. Once finalised, BEPS will presumably offer more unified and better guidance on concepts like substance and push taxpayers undergoing business transformations to link up tax more effectively to such initiatives. Typically this results in additional savings and shareholder value.

And the advice to taxpayers?

The risk and opportunity landscape is changing materially so this is not the time to stand in the water. However, while take-the-money-and-run is not really an option, run-for-the-money may be. Running meaning, developing a much deeper understanding of the transfer pricing risks involved, better and more business integrated planning (which will now carry on opportunity premium) and seeking even more upfront certainty.

To be a winner, one needs to run like hell.

A shifting transfer pricing landscape

Transfer pricing (TP) is once again the subject of a strong focus by the Australian government and the Australian Tax Office (ATO), explain Tony Gorgas, Damian Preshaw and Sean Wright of KPMG Australia.

Last year saw the introduction of new legislation dealing with TP, strong and consistent messages from both the previous and new Australian governments with the aim of stemming perceived erosion of the Australian tax base and profit-shifting practices of multinational enterprises and a restructuring of the ATO's compliance areas to better respond to the evolving landscape.

Not only has Australia sought to address TP through more definitive laws and their alignment with Australia's tax treaties and the OECD's TP Guidelines, new record keeping or documentation requirements with respect to TP have also been introduced and more closely aligned with the existing legislation framework.

While some things may remain the same, there has been movement in the ATO's compliance activities towards more specific areas of leakage such as payments that are often characterised as "market support payments".

New laws

New TP laws were introduced in 2013 in response to the ATO's loss in 2011 in the Full Federal Court case of *Commissioner of Taxation vs SNF (Australia) Pty Ltd*. In this case, the court found the existence of ongoing losses in an Australian subsidiary does not necessarily mean that the price paid to international related parties is not an arm's-length price.

This case highlighted the difficulty faced by the ATO, under the then existing TP provisions, in applying a profit-based methodology in a situation where the taxpayer was in a period of continued loss. The new legislation differentiates itself from its predecessor given its focus on profit as a key consideration in determining whether transactions between international parties have been undertaken on an arm's-length basis.

The aim of the new laws is to modernise Australia's TP rules and to ensure consistency in their application between both tax treaty and non-tax treaty cases. As with Australia's previous TP rules, the new provisions are sufficiently broad to capture non-arm's-length dealings between both related and unrelated parties.

One of the more positive outcomes of the new law has been a change of the period for amendment. The new legislation limits the period for amendment to seven years, and while this is still longer than that of the general tax provisions of four years, it is undoubtedly better than the previous situation where there was no limitation on the period to amend.

In addition the new TP legislation is aligned with the more general policy intent of self-assessment. Consequently the new rules are self-executing. This, however, places a higher degree of emphasis on taxpayers, and particularly public officers, who must form a view at the time of lodgement of the income tax return that dealings have been structured and priced on an arm's-length basis for tax purposes, for which they may be held accountable.

A key aspect of the new legislation is that it does give the ATO power to reconstruct dealings (Section 815-130), in exceptional circumstances. Exceptional circumstances include inconsistency in the form and substance of a particular arrangement and situations where the arrangement is not one that would have been entered into by independent parties acting at arm's-length. The reconstruction provisions in section 815-130 are intended to be consistent with those described in paragraph 1.65 of the OECD's TP Guidelines.

As well as specific legislation to include both trusts and partnerships (Subdivision 815-D), the new legislation also has application to entities with permanent establishments (Subdivision 815-C). The application of the permanent establishments rules in Australia provide for the allocation of income and expenses between an entity and its parts to be reflective of that between separate entities dealing wholly independently with each other.

The last piece of the new TP legislative package relates to the introduction of new record keeping or documentation standards (Subdivision 284-E of Schedule 1 of the Tax Administration Act 1953). While the new record keeping requirements are not mandatory, there is a penalty risk which may only be mitigated through contemporaneous documentation that meets a "reasonably arguable position" (RAP) standard. Once again the self-assessment regime will dictate the importance of this process to those managing tax risk and especially public officers who must make declarations in regards to the contents of annual returns provided to the ATO.

These new laws will be supported by the introduction in 2012 of the ATO's International Dealings Schedule (IDS) which must be lodged with the annual income tax return where taxpayers have international related party dealings of more than $2 million per year. The IDS requires disclosure of international related party transactions, TP methodologies, together with an indication as to the level of documentation held for any international related party dealings. The IDS is used as a risk assessment tool by the ATO to better target compliance activities and focus resources on high risk areas in its international tax programme.

Unlike the previous legislation which went relatively untested for 30 years, there is an expectation that the ATO will seek to test the new TP rules fairly early as it is the cornerstone to the Australian government's strategy on base erosion and profit shifting (BEPS). The new law will also be supplemented by the ATO issuing a number of new and revised TP rulings and practice statements. A number of these are due for release in draft form in the second quarter of this year.

BEPS strategy

Prime Minister Tony Abbott has indicated his intention to have Australia at the forefront of G20 initiatives. In his statement upon assuming the G20 Presidency, *G20 2014: Overview of Australia's Presidency* (December 2013), Mr Abbott signalled his government's intent in stating that "Australia will lead stronger international cooperation in the G20 to combat tax base erosion and profit shifting, including better global exchange of tax information".

The prime minister re-affirmed his views in his address to the World Economic Forum in Davos, (January 2014), where he stated that he hoped the G20 would continue to tackle businesses artificially generating profits to chase tax opportunities, noting "The essential principle is that you should normally pay tax in the country where you've earned the revenue".

The Australian government has been overt in its statements regarding its intention to use the G20 presidential term to demonstrate strong leadership in this area. Unsurprisingly, the ATO is tasked with providing major intelligence and deliverables to support these statements. Specifically a new taskforce has been set up with its focus being:

- To work with international partners to establish the purpose of Australian businesses in low-tax jurisdictions.
- Address BEPS through compliance activities, including bilateral and multilateral audits, supported by newly implemented laws.
- To understand digitalisation of the Australian economy and the implications for the tax system.

Biography

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Damian is a director in KPMG's transfer pricing services practice in Melbourne.

Damian advises clients in a wide variety of industries on transfer pricing and profit attribution issues with a special focus on dispute resolution, financial services and business restructuring. Damian represented the Tax Institute in consultation with Treasury on the recent review of Australia's transfer pricing rules.

Before joining KPMG, Damian was an international tax counsel in the ATO's transfer pricing practice where he focused exclusively on international transfer pricing and cross-border related party financial dealings. He was extensively involved in the ATO's transfer pricing rulings programme and was an Australian delegate to the OECD's Working Party No. 6 and its steering group on transfer pricing from 1994 to 2003.

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Sean joined KPMG in late November 2013 after 37 years with the Australian Taxation Office (ATO), 25 of which he worked in transfer pricing matters. He has a deep understanding of ATO products, processes and programs and brings to the table highly developed skills in risk analysis, negotiation and dispute resolution and in the development of transfer pricing strategies across a broad range of industries including pharmaceutical and chemicals, media and technology, telecommunications and retail and consumer products.

Sean's experience includes leadership in all forms of active compliance work including audits, risk reviews, APAs and in the resolution of this work through APAs, settlement, mutual agreement procedure or through less formal approaches. His experience in transfer pricing work also includes critical review of transfer pricing documentation and chairing ATO transfer pricing review panels to guide and support transfer pricing work in the ATO.

- To support Australian and OECD policy development.

In addition to annual compliance activities, including TP and its advance pricing arrangement (APA) programme, the ATO has recently launched another compliance project, ISAPS (international structuring and profit shifting), related to its BEPS strategy. Thes ISAPS project consists of around 120 risk reviews commenced in the last quarter of 2013 and continuing throughout 2014 forming the basis for an audit programme likely beginning in late 2014. The areas covered by this project are broader than just TP and include permanent establishments, thin capitalisation, controlled foreign companies (CFC), and particularly offshore trading hubs and business restructures.

While the ATO is playing down these inquiries as "big picture", the breadth of the ISAPS questionnaire does extend beyond the scope of Australian operations to trading partners and others in the group. The ATO has indicated that it will not be using formal powers (Sections 264 and 264A) at the beginning of this process, it may however, use formal powers where responses are untimely or incomplete. Apart from those taxpayers selected for this project it is also likely that other international compliance work will contain either these questions or, at least, a subset of them. In any case the ATO is likely to have a strong focus on the supply chain and the location and activities of group entities.

Given the looming dates for amendments to the OECD TP Guidelines in the areas of intangibles and documentation and the Australian government's declared interest in leading issues in TP and BEPS during its presidency of the G20, it is not unreasonable to envisage that Income Tax Regulations would be made soon after any amendments to the OECD TP Guidelines are finalised so that taxpayers and the ATO are required to have regard to such changes for purposes of preparing their income tax returns going forward.

Restructure of ATO compliance areas

With the appointment of a new commissioner of taxation in January 2013 it is not unexpected to see some changes in the ATO's internal structure. Of particular relevance is the restructure of the Compliance areas of the ATO. The major changes are to remove the small and medium enterprise and large market approach to compliance work. In its stead is a focus on Public Groups and Internationals (PG&I) and on Private Groups and High Wealth Individuals (PG&HWI).

Essentially this has changed the focus of the PG&I group from the management of around 1,300 corporates to tens of thousands. This enlarged group of taxpayers has resulted in a few problems around resourcing, particularly servicing the lower end of the market, and required a reshaping of the risk differentiation framework (RDF) that the ATO uses to classify taxpayers and their compliance risks. Information on the ATO's RDF can be found at www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-business-and-tax-compliance-publication/?page=42. While it is expected that these teething issues will sort themselves out over time, at least in the shorter term, understanding the ATO's directions in some of its more established programmes is proving a little difficult.

Capital (or market) support payments?

Market support payments have been the subject of a number of papers over recent years, particularly in the wake of the financial turmoil. These were seen as a reasonable approach in supporting a multinational group's focus in a particular jurisdiction and to remain strategically placed to benefit from the eventual upswing in market conditions.

While these may have enjoyed some degree of success in implementation, particularly in bi-lateral activity between tax authorities, the ATO has provided its preliminary view in Tax Determination TD 2014/D1 which focuses on instances where such payments are considered to be of a capital nature.

Australian tax law differentiates both income and deductions based on an item's classification as being of a revenue or capital nature. This is important as, simplistically, the general provisions of the law provide for income and deductions of a revenue nature in the calculation of taxable income. Capital profits or losses are brought to account for Australian income tax purposes under specific, event driven, provisions.

Consequently, as TP transactions underpin the numbers of a profit and loss account, such transactions are generally considered to be of a revenue nature and income or deductions for Australian income tax purposes. However, the ATO has identified some of these types of payments to be of a capital nature, taking the view that some are for the purpose of providing financial support and more akin to capital injections to ensure sufficient operational cash flow for continued trading.

While specific marketing support strategies may be acceptable when related to products and services, it is important in the Australian context that there is sufficient nexus between the characterisation of the payment and the purpose for which it is being used.

Further changes in the landscape in 2014

Notwithstanding the changes to the TP landscape in Australia and internationally in recent years, further changes are likely to occur in 2014.

At the international level, late 2014 deliverables under the OECD's BEPS Action Plan are likely to be influential on the Australian government's thinking and the ATO's administration of TP.

Domestically, there are also a number of events that are likely to result in further changes to the TP landscape, including:

- Expected reductions in Australia's thin capitalisation safe harbour limits (for many taxpayers this will mean an effective reduction in the maximum ratio of debt to equity from 3:1 to 1.5:1);
- The government's response to the Board of Taxation's Review of Tax Arrangements Applying to Permanent Establishments; and
- Inspector-general of taxation's review into the ATO's management of TP matters.

We live in interesting times.

China in the changing international landscape of TP

Cheng Chi, Kelly Liao, Brett Norwood and Irene Yan of KPMG China explore recent developments to which taxpayers in China may want to pay special attention.

In recent years, the Chinese tax authority has repeatedly raised issues it feels have not been adequately addressed by the OECD Transfer Pricing Guidelines. It has suggested that greater attention should be given to problems and issues encountered by developing countries, emphasising practical solutions. Multinational enterprises (MNEs) operating in China may want to increasingly take into account transfer pricing issues China and other developing countries indicate are particularly important.

Transfer pricing and developing countries

With respect to base erosion and profit shifting (BEPS), action items 8, 9 and 10 of the BEPS Action Plan aim to ensure that transfer pricing outcomes are in line with value creation. This is broadly consistent with opinions expressed by the Chinese tax authority in the *United Nations Practical Manual on Transfer Pricing, Chapter 10.3 China Country Practice* (*UN TP Manual* CCP) and elsewhere, which lay out some of the issues of particular interest to the Chinese tax authority.

The BEPS Action Plan emphasises that the pricing of intangibles for transfer pricing purposes should be consistent with the value created by the intangibles. This idea is universally applicable regardless of a country's development stage. Of particular relevance, though, is that the marketing activities of many companies operating in China may be viewed as creating market-based intangible assets, distinct from those pre-existing in other jurisdictions, and should be allocated a level of profit consistent with their value.

The BEPS Action Plan also suggests that specific rules should be adopted to ensure returns are not allocated to an entity solely because it provides capital or contractually assumes risks. Some observers have noted that this may be inconsistent with the arm's-length principle, as there are a number of instances where a third party is awarded returns primarily because of supplying capital or assuming risk. Nonetheless, based on our experience the Chinese tax authority also emphasises an alignment of employee activities with profit allocation, and companies characterised as performing limited functions and assuming risks (especially in the sense of Guoshuihan No. 363 [2009]) should particularly note that if a profit ceiling is set in accordance with a limited risk profile, then a (positive) profit floor may also be determined.

In addition, expanding on the alignment of transfer pricing outcomes with value creation, as indicated by the Chinese tax authority in the *UN TP Manual* CCP, location specific advantages are also identified as a potential profit driver. MNEs sometimes achieve savings on raw materials, labour force and rent expenses in some jurisdictions. Because of the still-maturing nature of the Chinese market, limited market competition and strong purchasing power of some Chinese consumers, cost savings, and market premiums reflected in higher prices or demand quantities, may be

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Brett frequently speaks at industry events, tax forums and webinars and often gives presentations in Chinese to local, provincial and national level tax authorities.

Brett has led the documentation efforts for companies with several dozens of entities across China, advised taxpayers regarding their transfer-pricing audits in China, and also advised multiple-state and privately owned China-based companies expanding their operations overseas. In the US and China, he has served clients in a variety of industries including financial services, consumer goods, manufacturing, automotive, advertising/marketing services, etc., analysing cross-border transactions in Asia, Europe, and America. Brett has been recommended as a leading transfer pricing advisor in China by the Legal Media Group since 2011.

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In addition to lecturing at many national and local training events organised by the Chinese tax authorities, Cheng has provided technical advice on a number of recent transfer pricing legislative initiatives in China. He has been recommended as a leading transfer pricing advisor in China by the Legal Media Group.

regarded as profits created from location specific advantages and, therefore, should be taxed in China.

Focusing on the value chain

Action item 13 of the BEPS Action Plan proposes to re-examine transfer pricing documentation rules, including requiring MNEs to provide all relevant government bodies with specific information in a uniformed template disclosing their global allocation of income, economic activities and taxes paid in each country. On January 30 2014, to gather comments, the OECD issued a discussion paper on transfer pricing documentation and country-by-country reporting, including a revised draft guideline. This initiative will expand the information disclosure obligation of MNEs from focusing on a specific part of a value chain in one country to focusing on the entire value chain of the world wide group. This is of particular importance for taxpayers in China, where contemporaneous documentation requirements have been in effect since January 1 2008 (see Circular 2), and documentation reports are already widely collected, reviewed and graded throughout the country on an annual basis; and in practice, we do find that China tax officials already focus on value creation in controversy and advance pricing agreements (APA) discussions with individual taxpayers.

More publicly, in the *UN TP Manual CCP* the Chinese tax authority indicates that it is essential to understand the contribution of companies operating in China within a group's global value chain. Guoshuifa No. 2 [2009] Implementation Measures of Special Tax Adjustments (Provisional) ("Circular 2") Article 14 also states that contemporaneous documentation should disclose many specific details, including "taxes of income tax nature, the rates and tax incentives applicable" as well as "legal representatives, senior management, such as board members or managers" and other relevant information on related parties. If the country-by-country requirements laid out in the BEPS Action Plan are adopted, more information will be available to tax officials. As a result, the Chinese tax authority could more easily analyse the contributions, profit allocation and tax burden of companies operating in China within the global value chain. In addition, the availability of such information potentially allows for broader applications of profit split methods, which

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Prior to 2003/2004, Kelly also assisted many multinational companies in corporate tax advisory and merger & acquisition tax advisory.

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Irene Yan joined KPMG Beijing in 1993. With more than twenty years experience with KPMG, Irene has broad knowledge in various PRC taxes, including, particularly, corporate income tax, indirect tax and individual income tax.

Irene has conducted research and has been actively involved in PRC inter-company transfer pricing practice since late 90s. She has rich experiences in group tax optimization, Tax Efficient Supply Chain Management, transfer pricing risk assessment, economic analysis, cost sharing arrangement, transfer pricing dispute resolution, advanced pricing agreement and contemporaneous documentation. Her experiences cover diverse markets, such as pharmaceutical, chemical, energy, food, retail, automotive and information industries. Her clients include a number of multinational enterprises with investment in China as well as large-scale state-owned enterprises and private companies with outbound investment.

the Chinese tax authority could use as an alternative method to the transactional net margin method (TNMM), which we find the Chinese tax authority sometimes believes undervalues the contribution of the Chinese entity.

Intra-group service fees under scrutiny

Many MNEs charge intra-group service fees to affiliates for supporting services (for example finance, HR, IT) rendered by global and/or regional headquarters, or by shared service centers. However, the Chinese tax authority remains committed to protecting its tax base from inappropriate charge-out costs. Similarly, action item 10 of the BEPS Action Plan aims to, among other things, develop rules "protecting against payment such as management fees and head office expenses". Consistent with the concerns of the tax authorities of many other countries, especially those of developing countries, China's State Administration of Taxation (SAT) may increase scrutiny on outbound service fee payments. Based on our experience, as well as public speeches made by senior tax officials at the SAT, costs allocated to Chinese affiliates in connection with supporting services may be considered shareholder costs, and may be treated as non-deductible to the extent they do not add value to Chinese affiliates. We expect that scrutiny in this regard will continue to be particularly vigilant. Taxpayers should ensure that supporting services provide actual benefits to Chinese affiliates, use appropriate transfer pricing methods to determine the service fee amounts, and maintain sufficient documentation, to minimise deductibility issues in China.

Nonetheless, some relief was provided regarding remittance this year in terms of Announcement No. 40 [2013], jointly issued by the SAT and the State Administration of Foreign Exchange (SAFE) in July 2013. It converts the advance tax clearance system into a tax recordal filing system, with the effect to simplify and expedite outbound remittance for items such as service fees. Though this announcement is consistent with the general trend to gradually relax China's foreign exchange controls, the Chinese tax authority still reserves the right to conduct post-remittance examinations, which may lead to penalties and late payment surcharges if additional tax assessments are made. Also, it may take a period of time before the practices outlined in this announcement are completely implemented in all localities.

Tax controversy going forward

Action Items 5 and 6 of the BEPS Action Plan together propose to address harmful tax practices and improve the transparency and substance of transfer pricing arrangements, and to prevent treat abuse, respectively. As touched on above, we expect that increased transparency will allow the Chinese tax authority to more easily identify potential audit targets, have more information to make use of during audits, and even allow for the use of methods other than the TNMM, such as the profit split method, to be utilised more often. In addition, taxpayers should be aware that China's general anti-tax avoidance rules (GAAR), outlined in Chapter 10 of Circular 2 (Articles 92-97), may increasingly come into play.

Chinese tax officials are explicitly empowered by law to investigate using GAAR if tax avoidance arrangements are identified in relation to abusive use of preferential tax arrangements, abusive use of tax treaties, abusive enterprising structures, tax avoidance by means of tax heavens or other arrangements without reasonable business purposes. In the context of the BEPS initiative, taxpayers should pay attention to the commercial substance of their overseas related parties with which Chinese entities have cross-border transactions, especially group entities established in suspected tax heavens. Chinese tax officials are increasingly familiar with tax structures commonly adopted by MNEs, and the Ministry of Commerce publishes information on foreign direct investment (FDI) on its website (www.fdi.gov.cn). For example, based on such statistics, FDI into China from Hong Kong has been roughly half of the total annual FDI into China, and FDI from the British Virgin Islands has been a multiple of that from the US in several years. Given the BEPS Action Plan, existing Chinese GAAR and the increasing sophistication of Chinese tax officials, special considerations should be given by taxpayers to the staff employed, assets utilised, risks assumed and decision-making capabilities of these overseas related entities in the future.

Transfer pricing regulations going forward

Circular 2 was published in 2009, retroactively effective as of January 1 2008, as a provisional measure to provide guidance to Chinese tax officials and taxpayers regarding transfer pricing and certain other tax matters, such as GAAR, controlled foreign corporations, and thin capitalisation. In response to observed practical implementation issues and the ever-changing transfer pricing environment both inside and outside of China, we expect that a revision of Circular 2 will be forthcoming. Although it is not known when a revision will be adopted, or what the exact changes will be, based on our experience during the years since the adoption of Circular 2, possible areas of interest to taxpayers that could be touched on might include:

- Guidance on GAAR for implementation purposes;
- Transfer pricing method(s) for related-party share transfers;
- Transfer pricing documentation thresholds;
- Disclosure requirements, for example regarding country-by-country reporting, or greater disclosure obligations for overseas related parties;
- Issues mentioned in the *UN TP Manual CCP*, such as location specific advantages, service fee deductions, and locally-generated intangibles; and
- Guidance on avoiding double taxation as a result of the self-adjustments in the five-year follow-up period post transfer pricing audits.

Expert panel

Pursuant to internal procedures announced in 2012, the SAT has established an expert panel mechanism to provide professional opinions on transfer pricing audit cases where:

- The registered capital of the entity under review exceeds a certain threshold or the entity has an annual average operating revenue above a certain threshold; or
- There is an industry-wide or nationwide investigation; or
- The Chinese tax authority considers the case to be significant.

Some tax authorities at provincial and municipal levels, such as in Guangdong province, have established expert teams to review and assess the technical merits and adjustment scenarios of transfer pricing audit cases. It should be noted that since this creates one more body to review the methodology, audits going through expert panel review have the potential to proceed more slowly.

The expert panel at the SAT-level aims to standardise the transfer pricing investigation procedures across all levels of the Chinese tax authority. Feedback provided to the audit working team after the expert panel review is intended to improve the quality of analyses and materials supporting the transfer pricing adjustments. It is also worth noting that the expert panel review result (for example profit range and adjustment method) of an industry-wide transfer pricing audit may be viewed as a precedent case for future audits in the same industry.

Leading voice

Many of the ideas proposed in the BEPS Action Plan are consistent with trends we observe having taken place in China in recent years. As the BEPS proposals are refined and the position of the Chinese tax authority crystallises, this represents an area of importance which taxpayers should follow closely. At the same time as the SAT is becoming a leading voice in these international discussions, it is domestically proceeding at a rapid pace to advance its agenda of staunchly defending its tax base, including focusing on service fees, locally-created intangibles, revising domestic tax regulations and increasing the sophistication of its analyses. Taxpayers should pay close attention to these trends, as they could potentially broaden the depth and scope of tax investigations in the future.

Hong Kong's transfer pricing environment rapidly maturing

Kari Pahlman, John Kondos, Irene Lee, Sunkyung Bae and Jeff Chan of KPMG in Hong Kong take a look at the opportunities for companies in Hong Kong amid a fast changing transfer pricing environment.

One of the four Asian tigers, Hong Kong has long established itself as an international centre of commerce and finance, attracting a diverse array of companies and traders to its shores. Hong Kong only ranked behind the US and mainland China in terms of global Foreign Direct Investment inflows in 2012, thereby flexing its economic muscle and financial strength for the world to see. Opportunistically located at the core of the Asia-Pacific region and within a five hour flight to over half the world's population, Hong Kong is a launch pad for a growing number of Pan-Asian regional headquarters to access and manage major target markets in the region. Recognised in 2014 by the Heritage Index of Economic Freedom as the world's most liberal economy by for a record 20th consecutive year, opportunities continually abound for multinational corporations looking to recalibrate their operations and market focus to tap into an escalating consumption power of the Asian middle class.

Runway of opportunities in Hong Kong

Throughout its history, Hong Kong has always committed to ensuring that it has a straightforward tax system and a transparent legal framework to support its open door policy for businesses. While many countries globally including Asian neighbours such as Thailand, Malaysia and Singapore have rolled out headline grabbing fiscal policies and tax incentives to attract investment, Hong Kong has quietly and steadfastly relied on the existing structure of its tax regime, which arguably still is a hidden gem amongst the jungle of noise. The territory has comparatively low corporate income tax rates, a source-based regime of taxation and does not apply withholding taxes to dividends or interests and virtually bears no customs duties. The Inland Revenue Department (IRD) is also aggressively expanding its tax treaty network and enacted new legislation on information exchange to raise its profile as a well-reputed and transparent international hub. These factors facilitate Hong Kong continuing to pull in a lion's share of companies establishing centralised trading and distribution hubs in the Asia-Pacific to realise cost synergies and operational efficiencies through the centralisation of functions such as sourcing and procurement, trading and sales, treasury, and the ownership of IP.

Multinationals managing their business operations in this way have commonly sought to analyse whether any of the profits generated by these activities are sourced outside of Hong Kong and hence not taxable in Hong Kong. As the provisions in law are more principles based, the more detailed guidance has been left to the courts of law, which have over the years regularly been called upon to decide on the source of profits. While the case law contains some divergence, the decisions of the past few years have shown a consistent application of certain key principles to decide on the source question. Hence, the certainty around the arrangements is arguable higher

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John specialises in financial transfer pricing and completed a large number of financial services APAs as well as transfer pricing audit defence and controversy management in Japan, China and across the Asia Pacific region working globally with tax authorities in the US, UK, Germany, Canada and other key jurisdictions.

Within banking John's experience includes: global trading, commercial and corporate banking, syndicate lending, investment banking, prime brokerage, cash equities, black box and algorithm trading, custody and wealth management. John has also advised on complex risk transfers and redesigned profit splits to cater to unique emerging market characteristics as well as restrictive regulatory environments in Korea and other Asian countries.

John also has extensive experience in asset management (traditional, alternative, PE and real estate), insurance (life and non life), reinsurance, treasury and intra-group service transactions, intangibles and restructures.

than in the past. Whenever the taxpayer's business and operational structure facilitates a due offshore claim, this presents a powerful opportunity for a potentially highly tax effective outcome for the overall supply chain profit. Numerous structuring alternatives exist in this space.

Critically, the burden of proof on the source of profits is on the taxpayer. Taxpayers may seek a formal advanced ruling from the IRD to obtain greater certainty regarding the source of profits, amongst other tax issues. The source of profits may also be resolved as a collateral issue in connection with an APA. In the absence of any formal ruling, companies pursuing an offshore claim in their Hong Kong tax returns are advised to maintain robust documentary and other evidence to satisfy any IRD queries.

It looks unlikely that Hong Kong would introduce any broader tax incentives but continues to rely on its natural market position and the benefits offered by the existing tax system. However, more specific initiatives to attract for example asset management industry and treasury operations are on the agenda.

Hong Kong's transfer pricing spectrum matures with APA programme launch

Against a backdrop of an expanding tax treaty network, the IRD introduced DIPN 48 – advance pricing arrangement (APA) in March 2012 to provide taxpayers an opportunity to use the APA framework to receive assurance regarding the acceptability of their transfer prices with the IRD and one or more tax authorities.

DIPN 48 indicates that APAs are only applicable on bilateral or multilateral basis, involving treaty partner countries. However, in triangular situations where one leg of the transaction is not covered by a tax treaty, there may still be room to negotiate with the IRD to cover this on a unilateral basis. Interestingly, IRD did indicate in connection with the public consultation on the APA rules that APA would become the only avenue to obtain certainty on transfer pricing matters, however, in practice there have been cases where IRD has provided advanced certainty on a transfer pricing matter through the regular ruling process. This is appropriate, particularly given that the APAs will only apply in a bilateral context.

Because of the relative inexperience of the IRD in dealing with APAs and the fact that Hong Kong's tax treaty network, whilst growing rapidly, is still limited, the popularity of the programme has been moderate to date. However, APAs are expected to become more common in the future as Hong Kong signs more tax treaties and tax authorities globally continue to step up their enforcement and scrutiny of transfer pricing.

In a Hong Kong context an APA would be most relevant to:

- Taxpayers who have had transfer pricing audits and adjustments in the counterparty jurisdiction (such as China); and
- Taxpayers who are undergoing significant change or a restructuring in their operations which will necessitate a new transfer pricing policy.

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Her primary financial services experience relates to working with banking, asset management and insurance clients to manage and document their transfer pricing policies in China, Hong Kong and across Asia Pacific. She led the delivery of China transfer pricing compliance documentation for major international financial institutions.

In addition, Irene also spends much time in providing regional transfer pricing consulting and planning advices to a wide range of business activities in the areas of investment banking, brokerage, corporate finance, financial loans, cash pooling arrangements, commodities trading and advising clients on potential TP risks and opportunities.

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Sunkyung is a manager of KPMG's global transfer pricing services in Hong Kong with seven years of experience in transfer pricing. She has provided multinational corporations with various transfer pricing advice in relation to value chain management, intellectual property valuations, global transfer pricing planning and documentation, business transformation, cost allocation, and M&A due diligence.

Sunkyung works with Hong Kong-based clients with respect to their global / regional transfer pricing initiatives. She assists clients in developing a comprehensive and robust transfer pricing framework and preparing planning or compliance documentation to enhance their transfer pricing compliance in local jurisdictions as well as to improve their operational and tax efficiency.

Having also worked in South Korea and the United States, Sunkyung has served multinational corporations engaged in a wide range of industries including pharmaceutical, automobile, retail and consumer, energy and natural resources, shipping and logistics, financial and other services.

Regarding the first category, a vast majority of regional headquarters in Hong Kong are connected to group companies, generally performing manufacturing or distribution activities, in mainland China. The aggressive transfer pricing enforcement in China frequently results in tax audits and transfer pricing adjustments for such Chinese operations. With the instigation of the APA program by the IRD, Hong Kong companies shouldering these issues do have an avenue to pursue a bilateral APA between the IRD and the Chinese tax authority, State Administration of Taxation (SAT). This view is supported by the IRD which has publically indicated its expectation the first APAs will likely be concluded with mainland China.

Secondly, taxpayers restructuring their value chain which includes a Hong Kong entity may also consider prospectively approaching the IRD for a bilateral APA to obtain certainty over the proposed business restructuring and prospective transfer pricing policies. General restructuring fact patterns commonly seen in Hong Kong include:

- Growth from limited risk to fully fledged, value-added distributor or regional principal; and
- De-risking from regional headquarters to routine services provider / distributor.

Where business restructuring results in functions and risks being shifted or increased in Hong Kong, the trigger point for an APA would typically come from an overseas jurisdiction, where functions and risks may be reduced. Where de-risking and off-shoring of functions occur in Hong Kong, the trigger point will be on the Hong Kong side as the IRD would typically query any sharp change in taxable profits.

Transfer pricing enforcement: Asset managers on the fireline

Showing signs of its increased sophistication in tax and transfer pricing, the IRD has recently launched a large number of tax audits against asset managers in Hong Kong, taking many by surprise. The IRD has sought to comprehensively challenge the rudimentary cost plus transfer pricing methodology adopted by many companies in the industry and is dissatisfied with the absence of transfer pricing documentation by many of the companies audited. Asset managers are likely to see

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Jeff is a manager in the global transfer pricing services (GTPS) team in KPMG in Hong Kong.

Jeff commenced his career with the GTPS team in KPMG in Sydney where he was heavily involved in assisting clients with a broad spectrum of competent authority issues including APAs, transfer pricing risk reviews and comprehensive tax and transfer pricing audits.

In Hong Kong, Jeff has managed and provided a very diverse Asia-Pacific client base with transfer pricing and international tax assistance focusing on regional initiatives involving tax and transfer pricing planning advice, value chain management, preparation of global master file documentation and due diligence analysis.

Jeff holds a bachelor of commerce from the University of NSW and is a member of the Hong Kong Institute of Certified Public Accountants and a member of the Institute of Chartered Accountants in Australia.

that intercompany service fees, sub-advisory and marketing fees and other allocated expenses come under increasing scrutiny. Additionally, the IRD has also been attempting to recharacterise transactions, particularly in relation to the carried interest.

A key focus of tax authorities has been that the allocation of fees/income should match the cost base so that there will not be any affiliates incurring large costs but receiving a low share of benefits and gain. Emphasis is therefore being placed on the allocation of investment advisory fees between the offshore manager and the onshore investment advisors. In challenging fundamentally the past cost plus model, IRD clearly considers the apportionment of the investment advisory fee based on the contribution of the entities in different locations to be one of the most appropriate methods, hence leaning towards profit split type of methodologies. In light of these developments, it is very important for asset managers to conduct transfer pricing reviews and properly document functions performed by each of its entities.

As a broader takeaway from these audits, we observe that the hard-hitting IRD is asserting a tough message not only to financial services companies but all taxpayers that it clearly expects multinationals to more rigorously prepare transfer documentation to adequately support their intercompany policies. It is highly likely the IRD will look to target other prevailing industry sectors in Hong Kong with sustained queries and transfer pricing audits after exhausting the asset managers. Continued tax scrutiny was foreshadowed in Hong Kong's 2014-2015 fiscal budget, where the Hong Kong government has specifically singled out the IRD to "step up tax enforcement and to combat tax evasion and avoidance" to preserve the territory's revenue base.

Prepare to brace for impact of BEPS

Based on the above, the tax and transfer pricing landscape in Hong Kong is maturing rapidly, following the growth trajectory of more sophisticated tax jurisdictions. However, the global world of tax is now in a state of flux. The base erosion and profit shifting (BEPS) 15 step action plan produced by the OECD is advancing rapidly and countries are already reacting to that with variable pace.

Hong Kong's response to BEPS to date has been somewhat muted and more focused on observing the global developments. In response to a question in the Hong Kong Legislative Council, the secretary for financial services and the Treasury initially indicated that no immediate plans were underway by the IRD to respond to BEPS and while they were closely monitoring latest developments, local stakeholders will be engaged for follow-up actions in due course. The Legislative Council was further informed that the IRD has "no plans at this juncture to change current practices" as Hong Kong's current transfer pricing regime in DIPN 46 "has been operating well since implementation".

As the BEPS action plan bears fruit, Hong Kong will not be able to rest on its laurels. Hong Kong will need to manage its international tax reputation and secure that it will not fall back into being classified as a less transparent jurisdiction which could potentially facilitate tax strategies deploying base erosion and profit shifting. On the global arena, Hong Kong should seize the opportunity afforded and actively engage in with the global community to shape the recommendations and outcomes. Ultimately, Hong Kong will not be immune to the ramifications of BEPS and businesses in the region cannot ignore the discussion. On the domestic front, the government may still consider legislative changes to introduce more formalised and robust legal frameworks in certain areas, such as transfer pricing. Without a doubt, the continued work on BEPS will have far reaching consequences also for Hong Kong and while perhaps unlikely now, it may even ultimately call into question territorial and source based taxation regimes.

Takeaways

Hong Kong taxpayers have been put on notice by the IRD that the maintenance of robust transfer pricing documentation is a key area taxpayers need to improve on. Taxpayers who have no or poorly documented transfer pricing policies will quickly lose having any basis when under scrutiny from the IRD, which may then seek to reconstruct and recharacterise transactions, resulting in unfavourable outcomes. Taxpayers are therefore urged to carefully review, update and maintain their existing transfer pricing documentation and policies to appropriately mitigate transfer pricing risk. In high risk situations, APAs should be considered and when the government obtains more track-record in this area, more taxpayers are expected to rely on the programme.

Further, faced with the impending ramifications of BEPS outcomes, multinationals need to vigilantly monitor these developments and review their existing tax and transfer pricing arrangements. Where necessary, taxpayers can already now take pre-emptive actions to modify their existing structures to better align with the general principles outlined in the action plan.

The TP landscape in India: High tax, low collection

Authority aggression and the introduction of domestic transfer pricing regulations are creating challenges for taxpayers in India. KPMG in India's Rohan Phatarphekar, Rajan Sachdev, Karishma Phatarphekar, Vinod Mangotra and Alpana Saksena explore whether the outlook is brighter or if the trend of increasing taxpayer difficulty is set to continue.

With the rapid globalisation of the economy, tax authorities in India have become increasingly vigilant in scrutinising the inter-company transactions of multinationals. In just eight transfer pricing (TP) audit cycles beginning from financial year ended March 31 2002, Indian tax authorities have made TP adjustments close to $25.41 billion, including the adjustments of $11.67 billion made in the TP audit cycle completed in January 2013. The issues that are scrutinised have also matured to cover more complex transactions such as valuation of equity share infusions, creation of marketing intangibles, intra-group cross charges and financial transactions. While the tax authorities in India gear up to upgrade and focus further on cross-border transactions, the introduction of domestic transfer pricing regulations from fiscal year 2012-13 is likely to increase TP challenges.

Enforcement trends

Valuation of Shares

TP adjustments in respect of equity infusion in an Indian company have been one of the most controversial issues in the past two years. Revenue authorities alleged that share investments made by multinationals in their Indian associated enterprises (AEs) were undervalued and made adjustments on the difference between the actual issue price and the arm's-length price (ALP) by considering it as notional income. They recharacterised such shortfall as deemed loan purportedly advanced by the Indian AE to its overseas parent company and have even imputed notional interest in the hands of the Indian taxpayers. There have been several high profile litigations on this issue, where taxpayers have approached the High Court challenging the positions taken by the transfer pricing officers. Taxpayers are eagerly awaiting some clear guidance from the courts on this issue.

Advertising, marketing and promotion (AMP) expenditure resulting in marketing intangibles

The Indian Revenue examines whether marketing intangibles were created by Indian taxpayers by applying the bright-line test. Bright-line means the level of AMP expense of comparables compared with the AMP spend of Indian taxpayers. If the AMP spend of an Indian taxpayer is found to be excessive, it is concluded that such effort has led to the development of marketing intangibles that are legally owned by the foreign affiliate, and an arm's-length compensation (by way of reimbursement of excessive cost with or without a profit margin/markup thereon) should be recovered by the Indian affiliate. A related dispute arises in cases where the Indian taxpayer also pays a brand/trademark fee to the foreign affiliate. The arm's-length value of such brand/trademark fee could be determined at nil by the Revenue on the premise that

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Rohan has been advising multinational companies on transfer pricing issues from 1997 long before the transfer pricing regulations were introduced in India in 2001. Rohan has been recognised as a leading transfer pricing adviser and features in the Euromoney's Guide to the World's Leading Transfer Pricing Advisers 2013.

Rohan has also been rated in the top 10 transfer pricing advisers in India in a survey carried out among Indian taxpayers in January 2011 by an *International Tax Review* publication.

Rohan specialises in advance pricing agreements and has serviced clients across various industries including IT, ITES, Financial Services, Electronics, and FMCG.

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She has rich experience of 25 years with Indian Revenue Service and has supervised and audited more than 2000 transfer pricing audits during the period 2005-09. She also represented the Revenue before the Tax Tribunal for international tax and transfer pricing appeals in the period 2006-2007, and was twice awarded Certificate of Appreciation by the Ministry of Finance for her work.

She works closely with US competent authority on India US MAP cases and with the Indian tax authorities on advance pricing agreements. She has been rated in Top 10 TP advisers in India in January 2011 by *ITR*.

the Indian taxpayer's local market development activity has enhanced the value of brand/trademark owned by the foreign affiliate, thereby necessitating a pay-in rather than a pay-out.

In a landmark case of *LG Electronics India* (ITA No. 5140/Del/2011) in January 2013, a Special Bench of the Tax Tribunal held that the TP adjustment by the Revenue in relation to AMP expenses incurred by the taxpayer for creating or improving the marketing intangible for and on behalf of the foreign AE is permissible; and said function could be construed as provision of service by the taxpayer to the AE. This Special Bench ruling has been followed thereafter by other Indian tribunals in various other cases. Only in a few cases, the Tax Tribunals have expressed contrary views where the taxpayers have been able to distinguish the facts.

Intra-group services

Indian TP regulations do not prescribe any guidelines to establish the arm's-length nature of intra-group services. Indian Revenue officials generally rely on the OECD guidelines to ascertain the validity of such charges. In many cases, Revenue has determined the arm's-length value of the intra-group services as nil, alleging that such charges are simply a means of profit repatriation and leads to erosion of India's tax base. Taxpayers are expected to demonstrate (i) that such services are not in the nature of shareholder activity or duplicative; (ii) the authenticity of the total cost pool and the allocation keys used (iii) the need and the evidence of services received and benefit accrued. Indian tribunals have, however, decided in favour of the taxpayer in many cases, stating that the Revenue cannot comment or question the business or commercial need of the taxpayers for procuring such services, but can only determine the arm's-length charge. Here it is important to appreciate that establishing the genuineness of such cross-charges may be practically difficult largely because of the intangible nature of services and benefits received. Maintaining a robust documentation would eventually be the key from a taxpayer's standpoint.

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She has been nominated among the top 10 transfer pricing advisors in India by *International Tax Review*. In addition to corporates in India she has advised MNCs across the Americas, Europe and Asia-Pacific continents in planning their transfer pricing policies and dispute resolution.

She has been on working stints in US, UK, Germany and other countries in APAC and is is a prolific speaker. Karishma is on the panel discussion of FIT, ITR, IFA Mauritius, IFA India etc. She has penned numerous articles and papers for *the ITR, BNA, Tax Analyst, Outsourcing, ET,* and *HBL*.

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He spent formative years of his career with Arthur Andersen and subsequently was a part of core M&A tax team at PwC. Immediately before joining KPMG, Rajan was designated as the Asia-Pacific tax director of Honeywell Group. He was involved in making recommendations to the IRS on safe harbour provisions and advising on key TP issues impacting the industry.

Dispute resolution

Conventional dispute resolution mechanisms in India

The conventional appellate process under Indian tax law that starts at the level of Commissioner of Income Tax (Appeals) and then moves upward towards the Tax Tribunal and the courts has been supplemented with the dispute resolution panel (DRP) process.

Alternate dispute resolution mechanisms

Dispute resolution panel (DRP)

DRP is a collegiate of three Commissioners of Income Tax and, unlike the above conventional process, it is a time-bound process, which enables taxpayers to have certainty in terms of time spent in reaching the Tax Tribunal. However, until recently, the mechanism's functions and the legislative/procedural limitations had led to widespread disapproval from taxpayers, as most of the times the DRP's directions largely favoured the Revenue. In a few cases where the DRP's instructions were in favour of the taxpayer, it is now possible for the Revenue to challenge such directions before the Tribunal. The time barring nature of the proceedings (directions to be issued within nine months) also considerably limits the ability of the DRP members to do justice to all cases. To make the DRP mechanism more effective, taxpayers have recommended that its members should be full-time dedicated and independent empowered members, which would accord much-needed momentum to the DRP framework.

Mutual agreement procedure (MAP)

MAP provides a mutually acceptable solution for the governments of both transacting countries, thus avoiding double taxation for the taxpayers. Article 9 (dealing with AEs) and the article dealing with MAP of the Indian DTAs provide guidance on how to invoke MAP in the situation of a TP adjustment. In 2010, India and US competent authorities (CAs) concluded a series of mutual agreements by reaching a settlement on cost-plus margin percentages in the range of 17% to 20% for certain IT/IT-enabled service operations of Indian captive centres. The original TP adjustments were made using cost plus margins in the range of 25% to 30%. In the time since the 2010 settlements, not much progress has been made, though recent updates suggest that constructive dialogue between the Indian CA and the US CA has resumed.

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Vinod Mangotra voluntarily retired from the Indian Revenue Service on April 30 2010 as chief commissioner of income tax. He was with the Indian Revenue for 33 years and was awarded Certificates of Appreciation by the Ministry of Finance for work in the sphere of transfer pricing.

He participated in the OECD Global Forum on Taxation in Paris in 2005, represented India at transfer pricing multilateral discussions at the Australian Tax Office in 2009 and was a member of Indian delegation at IBSA (India Brazil South Africa) Heads of Tax Administrations Meeting in 2009.

He has been senior transfer pricing adviser with KPMG India since May 2010 and has been a regular speaker at various international tax and transfer pricing Conferences in India. He had also been to Japan in June 2012 for meetings and seminars organised by KPMG on transfer pricing and advance pricing agreements.

Advance pricing agreements (APAs)

The APA programme was introduced in 2012 to bring certainty in potential TP controversies.

The APA programme has been a relief to multinationals operating in India and has gained popularity, which is evident from the number of applications (146) that have been filed in the first year. Several rounds of discussions are already in process, with site visits being conducted in consultation with taxpayers. The experience of the taxpayers has been very positive as such visits are conducted to understand the taxpayers' operations rather than to investigate. International TP experts have welcomed the pragmatic approach of the Indian APA team. The first batch of APAs are expected to be signed by the end of March 2014.

Safe harbours

The Indian safe harbour rules provide circumstances where certain taxpayers can avail an option whereby cost-plus margins or transfer prices in respect of certain transactions like services related to IT/ITES and contract R&D, manufacture of automobile components and financial transactions (loans and guarantees) would be automatically accepted by the Indian tax authorities. Taxpayers availing the option would be able to safeguard their transfer prices against potential litigation for a maximum period of five years. However, most of the margins prescribed under the safe harbour mechanism are considerably higher than industry standards, even after factoring in the premium for the certainty accorded by a safe harbour. As such, the response from multinationals towards the safe harbour regime has not been enthusiastic. Taxpayers are still awaiting clarifications on certain subjective and interpretational issues regarding services covered, rationalisation of margins and procedural aspects surrounding this regime.

At present APAs could be a preferred option because of the positive, pragmatic and business oriented approach of the Indian APA team and the possibility of achieving a well negotiated price proximate to ALP. Further, while bilateral APAs would mitigate the risk of double taxation, the safe harbour mechanism will not be able to avoid potential double taxation.

India's perspective on BEPS – Intangibles and TP documentation

As part of the BEPS Bureau, India has been actively and closely involved in all the different action points of the BEPS action plan. India is expected to seek to implement the OECD-issued guidelines under the BEPS initiative where applicable. Specifically, developments in connection with treaty abuse, transfer pricing of intangibles, and the TP documentation rules are likely to have a significant impact on taxpayers and foreign investors in India. Action 8 of the OECD BEPS plan calls for developing rules to prevent BEPS when groups move their intangibles among their members; profits associated with the transfer and the use of intangibles should be appropriately allocated in accordance with value creation. India has adopted the OECD's approach on BEPS in relation to intangible-related returns, and concurs that such returns should reside with the entity which takes strategic decisions around creation of the intangibles and not with the entity which has mere ownership of title and funding capacity. India therefore believes that by adopting the ''significant people functions'' approach in determining the economic owner of intangibles, the problem of disconnect between profit and economic activity would largely be resolved.

As per the OECD's draft guidance on TP documentation and country-by-country reporting based on Action 13 of BEPS plan, lots of information is envisaged to be provided in the proposed two-tiered (master file and local file) TP documentation structure, with an aim to curb tax avoidance through TP mechanisms. The Indian Revenue is of the view that the proposed two tier structure would help them in making proper risk assessment of cases where TP audits are required and hence would also be beneficial to taxpayers.

Since the existing TP documentation rules in India require all the information as suggested in the master file to be maintained, the recommended documentation structure would result in minimal additional compliance burden for the taxpayers initially.

Taxpayers are concerned and waiting to see how the rules relating to sharing of the master file and country-by-country reporting template will shape up, considering the current TP audit trends in India. They advocate adequate safeguards to be built into the rules to ensure that such information is not generally made available and shared only when necessary under treaty information exchange provisions. Another important aspect from an Indian perspective is materiality; volume of transactions ought to be the key to trigger the maintenance of such detailed documentation.

Taxpayer hopes

The Indian Government has now provided two structured mechanisms in the form of APAs and safe harbours for taxpayers to achieve certainty on their transfer prices and to provide some relief towards reducing protracted litigation. It is expected that the DRP mechanism will be more focused and lead to a reduction in litigation and the MAP will progress smoothly to resolve pending cases. Taxpayers are also hopeful that some concrete guidance would be forthcoming in relation to the contentious TP audit issues. Further, many more changes in the TP arena are expected with the implementation of the BEPS Action Plan. Overall, the Indian TP landscape in the global arena should be carefully tracked in the coming years to witness whether the Indian taxation scenario folds up to boost foreign investor confidence in India.

A light at the end of the tunnel for Indonesia?

Iwan Hoo and Wara Kertiningrum of KPMG in Indonesia present an overview of the Indonesian transfer pricing regulations, examine the current Indonesian transfer pricing landscape and identify critical points that may further change the shape of the transfer pricing landscape in Indonesia.

Indonesian taxpayers have witnessed dramatic changes over the past few years to the local transfer pricing landscape. The enforcement of transfer pricing regulations in Indonesia has been the frequent issue of transfer pricing regulations, combined with pressure to fulfill the country's annual revenue targets. The significance of potential transfer pricing adjustments has diverted the tax authority's attention from the central transfer pricing issues and created an incentive for the tax auditors in the field to place more scrutiny on taxpayers' transfer pricing arrangements.

Most recently, the Indonesian Tax Office (ITO) issued revised tax audit guidelines in mid and late 2013.

History of Indonesian TP regulations

The ITO has had the authority to impose transfer pricing adjustments since the Income Tax Law was introduced in 1983; however, transfer pricing issues were not the main focus of the ITO at that time. However, the guidelines issued by the ITO in 1993 on the determination of transfer pricing adjustments and the requirement introduced in 2002, which mandate a disclosure of related-party transactions in corporate income tax returns have slowly caused changes. In 2007, specific ITO references were made to transfer pricing documentation even though no details of the requirements were provided.

Starting from 2009, taxpayers have been required to disclose additional details of related-party transactions in their annual tax returns and declare whether transfer pricing documentation is available. This includes a declaration on whether 15 specific areas have been addressed in the transfer pricing documentation.

The year 2010 became a turning point for the transfer pricing practice in Indonesia, with the ITO's issuance of detailed transfer pricing regulations, which provided clear guidance on transfer pricing issues, including the applicability of the arm's-length principle, basic requirements to determine whether the prices are in compliance with the arm's-length principle and documentation requirements. In the same year the ITO also issued guidelines on the mutual agreement procedure (MAP) and advance pricing agreement (APA). In 2010, taxpayers witnessed that the ITO started to implement the regulations more aggressively in practice during tax audits, objections and in the tax courts.

Recent transfer pricing scrutiny

Tax and transfer pricing audits are often triggered automatically, rather than determined based on a risk assessment. This is because under the Indonesian tax system, taxpayers are required to make significant income tax pre-payments and significant amounts may be withheld on payments to taxpayers in the form of domestic withholding taxes.

The actual tax liability is only determined at the end of the year when taxpayers file their annual corporate income tax returns. If the prepayments and tax credits exceed the actual tax liability, the taxpayer should, at least in theory, be entitled to a tax refund. However, a request for a corporate tax refund will automatically result in an immediate tax audit for all taxes. A tax audit can also be triggered under other circumstances, although this is somewhat rare in practice because of severe constraints to ITO resources.

Obviously, many areas of taxation are scrutinised by the ITO during a tax audit, but the auditors' attention to transfer pricing-related matters has been increasing greatly.

Following are some examples of challenging positions by the ITO in recent years:

- Disallowance of expenses incurred by Indonesian taxpayers relating to the payment of royalties and intra-group services without properly taking into account the taxpayer's business or economic circumstances. Often rejections were made because of a trivial administrative matter such as the lack of a patent certificate.
- Disallowance of using multiple-year data for benchmarking purposes and basing the conclusions on the results of the year under audit only, or using a two- or three-year analysis to achieve a desired outcome, while not taking into account the companies' business cycles.
- Insistence of using public market data that may not be comparable to the terms of the transactions being reviewed.
- Greater emphasis on product comparability as a criterion for the selection of comparables under the transactional net margin method.
- Selection/application of a transfer pricing method based on a very generic understanding of the company's business under review.
- Oversimplification of a company's business characteristics. Generally, the ITO categorises the characteristics of a company as toll manufacturing, contract manufacturing or fully fledged manufacturing. Other business setups are often simply placed into one of these three aforementioned groups.

Over the years the ITO's knowledge and understanding of transfer pricing has increased, although its interest in transfer pricing issues is still driven by the intention to fulfill the country's target tax revenue. This focus has made the ITO auditors target the taxpayers with the same scrutiny and adjustments in subsequent years. In some cases, the ITO has opened up previous years for transfer pricing audits.

Moreover, the efforts of the ITO to strengthen the examination of transfer pricing issues often impose further administrative burdens on taxpayers. Its latest issuance of tax audit guidelines includes templates requiring detailed information, which must be provided during a transfer pricing audit. The regulation does indicate that the forms can be customised to taxpayer's line of business although the same forms are used for all types of industries, which poses significant complications as the forms are very much geared towards manufacturing activities.

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He spent his career working in international tax and transfer pricing, starting in Amsterdam, the Netherlands. This was followed by a three-year stint in Jakarta, Indonesia. After his return to Amsterdam where he was with KPMG's transfer pricing team he transferred to KPMG in Singapore where he also joined the transfer pricing team.

Starting from 2009 he assisted the Indonesian transfer pricing group which he eventually joined in 2010.

Iwan graduated in tax law from the university of Leiden, the Netherlands.

The development of dispute resolution

Traditionally, taxpayers who disagree with adjustments made during tax audits could follow a process of filing an objection and, if unsuccessful, lodging an appeal with the Tax Court. At the moment, many transfer pricing-related cases are under review by the Tax Court.

Early in the implementation of the transfer pricing regulations, there were some delays in receiving a verdict from the Tax Court. Some assumed that this was because the Tax Court was not ready or familiar with the transfer pricing issues to make a conclusion. This has begun to change. Now we observe that the Tax Court is completing transfer pricing disputes at its ordinary pace, although the results of transfer pricing appeals are still less predictable than other types of tax disputes. Another complication has been recently added as the ITO appeals have lost transfer pricing verdicts to the Supreme Court, causing further delays and uncertainty for the taxpayers.

In view of all of these, Indonesian taxpayers are now considering alternatives to the domestic dispute resolution process, such as MAPs for which amended regulations were recently issued.

Taxpayers may also ensure that the pricing of related-party transactions will not be adjusted in the future by applying for

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Wara is a manager in the transfer pricing team of KPMG Indonesia. She has experience with various projects such as transfer pricing disputes, planning and documentation.

Before specializing in transfer pricing, Wara provided tax consulting and tax compliance services to a wide range of multinational and domestic companies in a variety of industry sectors.

Wara has nine years of experience and consulting practice and has in-depth knowledge of the full range of Indonesian tax issues, including VAT, corporate, employee and withholding taxes.

Wara also has extensive experience in cross-border transactions. Her clients cover variety of industry sectors, including: manufacturing, distribution, financial services, automotive, industrial markets and commodities.

an APA, which may involve the Indonesian authorities (unilateral APA) only or two or more authorities (bilateral or multilateral APA).

No official information is available on the number of MAPs or APAs submitted, but based on informal discussions, several have been already initiated and some are on the brink of conclusion. Although the outcomes of the MAP or APA processes are not yet proven in Indonesia, an Indonesian taxpayer may want to consider these resolutions to avoid potential double taxation.

Enforcement trends

In light of the current trends we hope and believe that the following developments could be anticipated in the Indonesian transfer pricing arena:

More adherence to international trends and practices

Up to now, the Indonesian transfer pricing regulations have been largely derived from the OECD Guidelines and the latest guidance to the tax auditors is in line with commonly accepted principles. Thus, it would be beneficial for multinational corporations to monitor the OECD guideline trends on transfer pricing structures for its Indonesian entities.

Recently, the ITO has been actively participating in discussions on BEPS. Although for the time being the majority of Indonesian taxpayers should not be directly affected by the BEPS initiatives, it is prudent that the BEPS initiatives and the potential implications should be taken into account when conducting related-party transactions with Indonesian entities. Global enforcement of more extensive transfer pricing disclosures will affect the transfer pricing in Indonesia.

Because of the tendency of the ITO to request detailed information in a short time frame during an audit or dispute resolution, it is recommended that Indonesian taxpayers ensure that transfer pricing documentation and, perhaps even more important, the underlying documents, are in place.

It is also important to note that any drop in the profitability levels of an Indonesian entity, regardless whether it was caused by economic circumstances or by changes to the company's transfer pricing policies, may likely trigger a tax audit.

The importance of a contemporaneous transfer pricing report

In the past we have observed that tax officers have often challenged a taxpayer's transfer pricing position with a completely different method or approach (often using information they regard as meeting the comparability standards of the CUP method). This situation is also beginning to change. The ITO is now giving more consideration to a taxpayer's position as documented in its transfer pricing report, although that does not prevent it from performing its own economic analyses. Thus, taxpayers, without contemporaneous transfer pricing reports, are losing an opportunity to manage the information and ITO's interpretation of the company's business at an early stage.

The challenges for dispute resolution remain

Although there have been some very positive developments in the dispute resolution area, such as taxpayers winning appeals at the Tax Court, the unpredictability of results remains and is still expected to exist in the short term. Furthermore, dispute resolutions in Indonesia are generally an exhaustive process, even more so for transfer pricing issues. Companies facing large tax adjustments or incurring this risk may want to consider taking an alternative resolution process through the use of an MAP or APA. A commercial decision needs to be taken among the available dispute alternatives in view that the ITO is also in its early stage of implementing the MAP and APA. A positive sign is that the ITO is actively encouraging taxpayers to consider these procedures so that Indonesia can start building a positive track record.

Opportunity to review Indonesian entity's transfer pricing structure

Considering Indonesia's early and changing transfer pricing regulatory environment, as well as the ITO's constant focus on transfer pricing issues, now is the time for multinational groups to review their transfer pricing structure, not only for Indonesia, but also for the group as a whole and, to plan ahead considering the wide impact of this issue. Changes in Indonesian transfer prices affect not only corporate income tax, but also withholding tax, VAT, luxury goods tax and even customs duties, all of which have interaction with the prices charged between the parties involved.

Changes in regulations

Taxpayers should anticipate more changes to the Indonesian regulations. While no formal announcements have been made, changes can be expected with regard to transfer pricing documentation requirements for smaller taxpayers. Also safe harbour provisions could possibly be considered, while changes to the MAP process and formalities also are expected.

Continuing developments

Developments in transfer pricing in Indonesia over the past few years have been swift and they are expected to continue. This creates both opportunities and challenges for multinational companies with business operations in Indonesia. While the current climate is still very challenging, there are some positive trends and a more level playing field may be on the horizon.

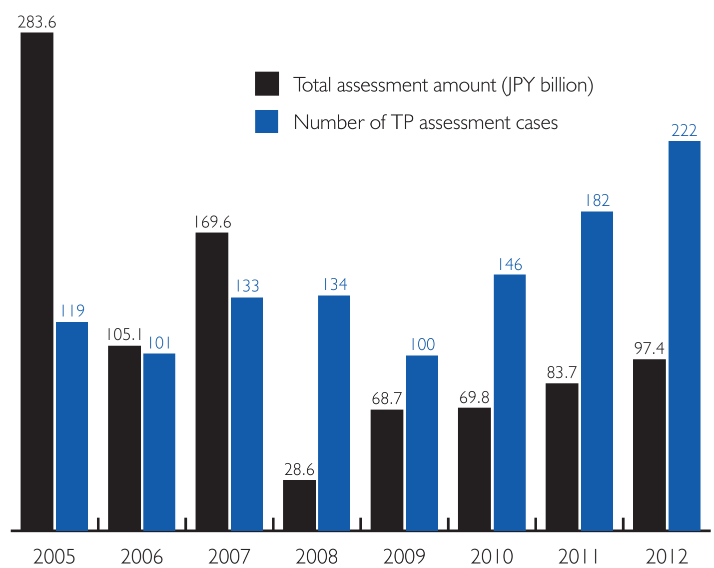
Increased focus on transfer pricing in Japanese tax audit

As challenges from various Asian tax authorities ramp up, one may think transfer pricing in Japan is no longer an issue. The focus of the Japanese tax authority might have been shifted from one transfer pricing issue to another and the types of challenges might have been changed as well; however, its emphasis on transfer pricing has never been diminished.

Audit trends

Transfer pricing taxation was introduced in Japan in 1986 and has been enforced for more than 25 years. As is well known, the Japan tax authority conducts audits on a periodic basis and each audit drills down into detail – such consistency and the detailed nature of the audits is probably one of the reasons why the Japanese tax authority is seen so tough.

According to the statistics the National Tax Agency (NTA) releases on an annual basis (see below chart), the aggregate amount of assessments has stabilised compared with the peak period but number of assessment cases has been increasing in recent years.



The decline in the total assessment amount indicates that big cases have already gone around, and/or companies with potentially significant risk have taken preventive measures, most commonly advance pricing arrangements (APA). On the other hand, the fact that the number of cases is high means that audit activity itself has expanded to include audits for medium sized companies, including subsidiaries of foreign multinationals.

The history of transfer pricing audits in Japan has had different characters depending on the year or the period the audit was conducted and the business/economic climate prevailing at that time. In the mid 2000's there were a lot of transfer pricing audits and assessments for Japan-based manufacturing companies. This is mainly because of the distorted profit distribution between Japan/offshore which was caused by companies relocating manufacturing plants overseas. While many manufacturers relocated plants, that is profit centers, overseas to achieve cost efficiency, the cost center such as administrative functions and R&D facilities remained in Japan. Without taking proper measurers to reallocate the profit, such movement led to profit shifting away from Japan.

Recently, the issue has become even more complicated. The first wave of offshore relocation was primarily focused on the manufacturing function, however, as globalisation progresses and the market potential of emerging markets grow, the offshore subsidiaries are starting to fulfill more non-routine functions as well. In other words, some of the non-routine functions, namely strategic marketing and/or R&D have also shifted offshore to stay close to the high growth market. Therefore, the issue which was primarily return on routine manufacturing now includes non-routine returns, and hence is much more complex. Also challenges from the overseas tax authorities over the return for the increased functionality are increasing.

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Tomoko Wada is a partner in KPMG Tokyo global transfer pricing services. She has more than 15 years of experience in managing and conducting transfer pricing economic analysis. She has practiced transfer pricing both in US and in Japan, focusing on supporting advance pricing agreements, audit defence, or planning studies to determine appropriate transfer pricing for multinational financial institutions. Prior to her transfer pricing career, she has worked for a financial institution as a corporate finance vice president.

Changes in the transfer pricing tax audit procedure

In Japan, transfer pricing audits had traditionally been conducted separately from the general corporate tax audits, by a specialised transfer pricing audit team within the tax authority.

The 2011 revision of the tax system in Japan included changes and clarifications on the tax audit procedure as follows.

- When commencing a tax audit, the tax authority, in principle, needs to provide a formal notification to the taxpayer which shows in advance what tax items (that is, corporate income tax, consumption tax, individual income tax) will be under the tax audit. Transfer pricing tax issues are considered as part of a corporate income tax item.
- When concluding a tax audit, in the event that the tax authority does not make a tax assessment, the tax authority should notify the taxpayer of this in writing. Therefore, once the tax authority issues a formal notification with no adjustment at the end of a corporate tax audit, this means no adjustment is made on transfer pricing as well.
- As stated above, transfer pricing tax audit and general corporate tax audit will be conducted at the same time as a single tax audit. However, in exceptional cases, a transfer pricing tax audit may be separated from a general corporate tax audit, in the event that the taxpayer agrees to have a transfer pricing audit conducted separately.

In summary, a transfer pricing audit will by default be conducted in conjunction with general corporate tax audit, and only when taxpayer's prior consent is provided, may the transfer pricing audit be conducted separately.

Under the new procedure, when a tax audit is conducted, the tax authority needs to draw a certain conclusion for both transfer pricing and general corporate tax, and such conclusions should be notified to the taxpayer. Thus, it is expected that transfer pricing issues will be examined in a more comprehensive and detailed manner compared with the past because conducting a separate transfer pricing audit for the same year is basically no longer an option for the tax authority.

It is important for taxpayers to prepare countermeasures in preparation of a transfer pricing audit, such as establishing robust transfer pricing policies based on proper transfer pricing analysis and preparing transfer pricing documentation to support and explain the taxpayer's position.

APAs

In Japan, APAs were initiated in 1987. According to the NTA report, Japan was the first country to implement an APA system, and is one of the most experienced countries in terms of APAs, given the long history and the number of cases handled so far.

The NTA has been recommending bilateral APAs as an effective way to manage transfer pricing risks. APAs provide merits to both taxpayers and the tax authority. Taxpayers can secure predictability and avoid contentious transfer pricing audits. At the same time, the tax authority can reduce the administration costs of conducting audits. According to statistics released by the NTA, roughly 130 APA requests have been made each year over the last few years.

The major APA counterparty countries are the US, followed by Australia and the UK. Reflecting the recent economic trend,

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He had worked for KPMG Singapore's transfer pricing practice for two years until January 2014, to develop and support KPMG's transfer pricing service for multinational Japanese companies in Asian region.

His project experience covers a range of projects such as transfer pricing risk analysis and planning, transfer pricing documentation and transfer pricing audit defence, as well as assistance for competent authority negotiation/bilateral advance pricing agreements involving the US, Singapore, China, Thailand, and Japan.

He is the Certified Public Tax Accountant (Japan).

cases with countries in the Asia Pacific region are increasing. During the recent five years, the number of APA cases agreed with Asia Pacific countries accounts for approximately one third of all the APA cases agreed, and as of June 2013 there were ongoing APA negotiations with eight Asia Pacific countries, which include Australia, South Korea, China, Hong Kong, India, Indonesia, Singapore and Thailand.

The APA negotiations with these new counterparties typically take longer because of insufficient negotiation experience and the lack of consensus on economic analysis approaches.

Transfer pricing documentation enforcement

What is happening post introduction of the TP documentation rules in 2010? The items requested in the documentation, which are stipulated under Ministry Ordinance, are similar to what is already in place in many other countries. However, what is unique to Japan is the penalty potentially imposed for not having documentation in place. There is no monetary penalty for not having documentation; however, failure to submit the documentation without delay entitles the tax authority to presumptive taxation.

When the new rules were introduced, the explanation by the tax authority was that the introduction of the rule is meant to encourage taxpayers to cooperate, and does not intend to aggressively enforce presumptive taxation unless necessary. So far this seems to be what is actually happening; as long as the taxpayer is willing to cooperate, the sanction has not been triggered. That said, one should not undervalue the fact that this is a formal requirement under the law – the clause information to be provided without delay implies flexibility but that is only when the audit is carried out in a cooperative atmosphere.

While the contents of the items requested are basically similar to those in other countries, one item that needs to be prepared besides the conventional transfer pricing documentation is the system profit information. This is to show the profit earned by each related party involved in an intercompany transaction, that is the total amount of the profit earned by the group companies in one transaction and the share of that pertaining to Japan. As the preparation of such segmented financial information takes considerable time, it is advisable to collate such information before the commencement of an audit.

Reaction to BEPS

The OECD Committee on Fiscal Affairs is chaired by a representative from Japan, and the Japanese government strongly supports the BEPS related actions taken by the OECD. The business has also received the overall initiative positively.

Not many Japanese companies have been engaged in aggressive tax schemes which the BEPS initiative is trying to address and it is perceived that the impact of BEPS on corporate tax strategies would be limited.

However, industry has raised strong concern over the OECD draft on country-by-country reporting requirements. Japan Business Federation (Keidanren) has released a comment stating that "it is unreasonable and counterproductive to impose excessive additional burdens on numerous corporations that have never been engaged in BEPS".

In fact, the reporting format as drafted seems to place significant compliance burden beyond what is currently requested, and many companies think that it is unfair that any taxpayer, including those who have been playing fair on taxes, have to bear an additional burden just because some taxpayers have been engaged in BEPS.

Further, companies are worried whether the information will be interpreted and used appropriately by the relevant tax administrations, and not just as a means to compare the amount of taxes paid in one country or another; this in itself does not mean much, or may even have an adversarial effect if the information is misused.

Navigating transfer pricing issues: Korean perspectives

The Korean government has been strengthening transfer pricing regulations in recent years. Gil Won Kang, Dong Kwan Kim, and Pius Tae Hyun Park of KPMG in Korea report.

On January 1 1996, the government of Korea enacted the Law for the Coordination of International Tax Affairs (LCITA) which included the first transfer pricing legislations in Korea. LCITA was drafted in accordance with OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines) and the government of Korea has been very active in incorporating the revisions of OECD TP Guidelines into the LCITA since its enactment.

In recent years, transfer pricing issues have attracted lots of attention from the Korean tax authorities. Significant efforts have been made to strengthen the transfer pricing regulations which included a series of amendments, including one made to reflect the most recent OECD TP Guidelines issued in July 2010, and development of specialists in the area of transfer pricing within the Korean National Tax Service (NTS). As a result, multinationals operating in Korea have been subject to greater transfer pricing scrutiny and have incurred significant costs in complying with the strengthened transfer pricing regulations.

Key changes to Korean transfer pricing regulation

Harmonisation of transfer pricing and customs valuation adjustments

In Korea, taxpayers who import from foreign affiliates often found it difficult to obtain customs refunds resulting from transfer pricing adjustments and vice versa. In an attempt to reconcile the differences in transfer pricing and customs valuation methods used by the two tax agencies, the Ministry of Strategy and Finance amended the LCITA and the Korea Customs Act to harmonise the transfer pricing and customs regulations. The newly enacted legislation, which became effective on July 1 2012, states that transfer pricing or customs valuation adjustments made by one tax authority should be respected by the other. Accordingly, the taxpayers are now able to protect themselves from overpaying taxes/duties resulting from adjustments made by one tax authority by requesting for corresponding adjustments to the other tax authority. This harmonisation regulation will provide an opportunity for the taxpayers to avoid potential double taxation arising from transfer pricing and customs valuation adjustments. According to the current interpretation of the legislation, there is a condition that must be satisfied for the refund application; the taxpayer must, within two months from the date the taxpayer became aware of the transfer pricing or customs valuation adjustments, apply for a refund to the other tax authority. Accordingly, taxpayers are being advised to understand and apply this new harmonisation regulation to obtain a refund on overpaid corporate taxes or customs duties resulting from the tax/customs audits.

Information exchange

In an effort to prevent offshore tax evasion by multinationals operating in Korea, the LCITA was amended to expand the scope of exchange of financial information under current tax treaties. Before the amendment, only non-residents and non-resident corporations were subject to the periodic information exchange. According to the amendment, the parties subject to the financial information exchange was expanded to include domestic residents and companies as well as any group of two or more individuals. In addition, financial institutions may be fined with a penalty up to KRW30 million ($28,000) for the lack of cooperation with the government's request. The effective date for the amended LCITA is January 1 2014.

In relation to the base erosion and profit shifting (BEPS) action plan, the Korean government is assessing the opinions of various stakeholders but has not expressed its stance regarding this matter.

Transfer pricing audit trends

In case of tax adjustments, NTS prefers year-by-year tax audit to term testing over multiple years. This preference can sometimes work against taxpayers who are unable to explain highly fluctuating yearly profits. However, it is not uncommon for the NTS to accept multi-year testing when dealing with transfer pricing adjustments and apply similar methods to the other years subject to review (subject to statute of limitations). The statute of limitations is five years from the day following the due date for filing the income tax return. When the taxpayers' transfer prices fall outside the arm's-length range, NTS generally adjusts the transfer prices to the median value from the benchmarking result.

Transfer pricing adjustments are subject to secondary adjustments in Korea. As a result, taxpayers may be assessed with additional taxes on the primary transfer pricing adjustments. Taxpayers are given 90 days to avoid the secondary adjustments. Most secondary adjustments are treated as deemed dividends subject to withholding taxes or as additional capital investment.

Recently, intercompany royalty charges for the use of brand names/trademarks have become a focus of the Korean tax authorities. In the past, the focus has been on whether the brand owner has been compensated for the use of its brand and there have been many cases where a significant tax assessment was made in this regard. However, because of the complexity involved in determining the value of the brands and the resulting royalty rates, the valuation method chosen by the taxpayer to determine its royalty rate has not been subject to many challenges. However, given the increasing interest by the tax authorities in the royalty charges, it is recommended that taxpayers be proactive in developing a reasonable valuation method and economic rationality to deal with potential challenges by the tax authorities.

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Gil Won was a member of competent authority team of Korea's National Tax Service and handled various negotiations with G8 nations. He continues to hold seminars for the Korean government and Korean multinational companies on transfer pricing issues.

During 2013, Gil Won has been appointed as the World's Leading Transfer Pricing Advisers by Euromoney's Guide and his transfer pricing team was also ranked as Tier 1 transfer pricing advisory group in Korea by International Tax Review 2013.

Recent tax audits show that the tax authorities closely scrutinise excessive intra-group transactions among affiliates. LCITA enforcement decree article 6 paragraph 2 states that for the intra-group service fees to be deductible, the following conditions must be satisfied:

- Actual services are provided in accordance with an agreement;
- service recipients expect to increase profit or reduce cost from the services;
- service fees are determined at arm's length; and
- documentation that verifies the above is prepared.

Taxpayers paying large royalties, intra-group service fees and/or commission fees based on sales to foreign affiliates are facing higher risk of transfer pricing challenges by the NTS.

General compliance

Benchmarking study

In identifying potentially comparable companies whose businesses are similar to that of the tested party, Korean tax

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Dong Kwan is a director of the global transfer pricing services of KPMG Korea. He has 20 years of experience in the field of Korean and international taxation. He has been providing tax advisory and compliance services to multinational companies in wide range of industries.

Prior to joining KPMG, Dong Kwan was part of the International Cooperation Office where he handled MAP and APA approvals with the US, UK and Japan analysing, reviewing and approving various MAP and APA cases. In addition, he was responsible for uncovering and resolving transfer pricing related issues for the multinationals doing business in Korea.

During his time as a tax examiner, he was involved in various tax audits involving transfer pricing, beneficial interest, permanent establishments, thin capitalisation and offshore tax evasion issues.

authorities generally do not accept a non-local benchmarking study and strongly favor the use of a Korean database called KIS-Line. KIS-Line contains financial and business information of more than one million Korean based companies that are subject to annual statutory audit requirements. The database is first screened for businesses that are engaged in the same or similar businesses which the tested party is involved in to arrive at the pool of comparables. The initially identified potential comparable companies are then screened using certain quantitative and qualitative criteria to eventually arrive at the final set of comparables. Examples of some of the most commonly used quantitative screening criteria used to eliminate non-comparable companies are as follows:

- Companies without at least three years of audited financial statements are eliminated;
- Companies that incurred consistent operating losses are eliminated; and
- Companies with significant R&D expenses or marketing expenses are eliminated if the tested party does not incur those expenses.

Working capital adjustments are usually applied in order to improve the comparability.

Biography

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Pius is a senior manager of the Global Transfer Pricing Services of KPMG Korea. He has 9 years of experience in the field of international taxation. He has managed many transfer pricing projects in North America, Asia and Europe, involving supply/value chain restructuring, APA/MAP negotiations, intra-group service arrangements, and transfer pricing documentations for multinational companies in wide range of industries.

Transfer pricing documentation

Although the preparation of transfer pricing documentation (TPD) is optional, a penalty relief can be provided to taxpayers who satisfy the contemporaneous documentation requirements. In case of a transfer pricing adjustment, underreporting penalty (that is,10% of the additional corporate income tax) may be waived if the taxpayer has maintained contemporaneous transfer pricing documentation by the corporate tax filing due date. A taxpayer who wishes to obtain the penalty relief should submit the documentation within 30 days when requested by the NTS and the documentation should contain the following information:

- General descriptions of the business;
- Information on foreign related parties and their relationships with the taxpayer;
- Economic analysis and evidence supporting the selection of the most reasonable transfer pricing method; and
- Profitability of the selected comparable companies and the descriptions of adjustments applied during the analysis of the arm's-length price.

Advance pricing agreement (APA)

The APA programme was first introduced on January 1 1997 in Korea and the number of APA applications per year has been increasing every year as taxpayers try to avoid unexpected tax issues from their operations and mitigate potential risks. In 2012, more than half of the concluded APAs were bilateral APAs requested by foreign multinationals. APAs can be unilateral, bilateral or multilateral, and can be sought for three to five-year period. A rollback can be granted for all three types of APAs up to five years.

Diagram 1

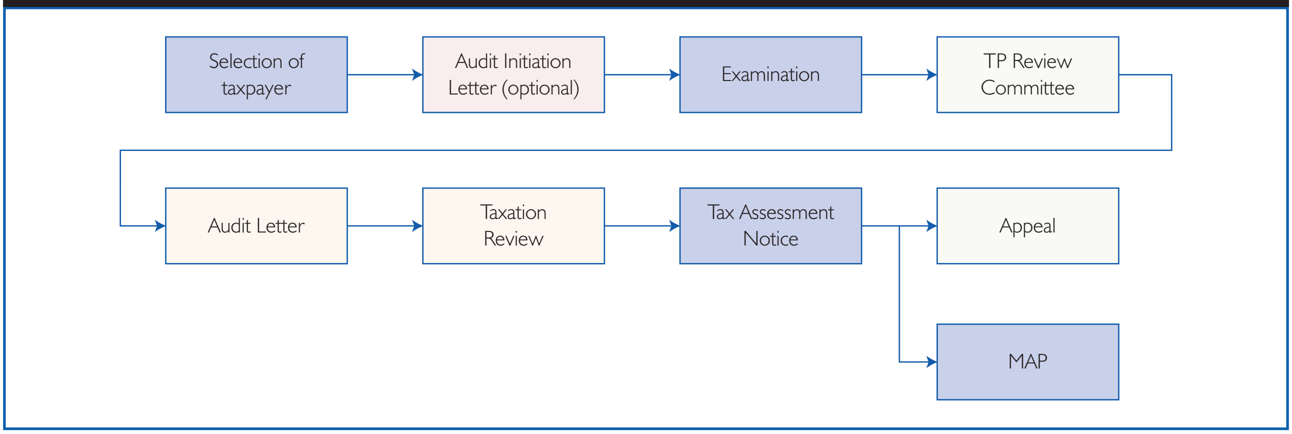


Table 1

1st Level:	• Taxation review	The appeals must be filed within 30 days of the receipt of the tax audit letter.
2nd Level (options):	• Secondary review by the NTS • Request for ruling by the Tax Tribunal • Appeal to the Board of Audit and Inspection	The appeals must be filed within 90 days of the receipt of tax assessment notice (taxpayers may also elect to only make the appeal in court).
3rd Level:	• Appeal in court	The appeals must be filed within 90 days of the receipt of tax assessment notice.

Unilateral APAs are usually concluded within 18 months while bilateral/multilateral APAs are generally completed within two to three years. Once the terms of the APA have been finalised, the results are legally binding to the NTS but not to the taxpayer. The taxpayer has the right to withdraw the APA without consequences.

The unilateral APAs are mandated by the LCITA to be completed within two years from the application date which makes the unilateral APA process to be more streamlined compared to the bilateral or multilateral APAs. Additionally, the approval process is handled by the International Co-operations Office, which is in charge of all APA negotiations, which allows the taxpayer to deal with the tax examiners who are specialised in transfer pricing. Accordingly, when dealing with transfer pricing issues, unilateral APAs provide more flexibility and benefits to the taxpayers than going through the general corporate tax audits which are generally conducted by tax examiners with limited transfer pricing understanding or experience. Having said that, taxpayers with moderate to high transfer pricing risks are encouraged to manage their transfer pricing risks through unilateral APAs.

When an APA approval is obtained, taxpayers are required to file an annual APA report which shows that the transfer prices have been determined by the method agreed upon under the APA. The due date for the annual APA report is within nine months following the end of the taxation year.

Transfer pricing audit process

Diagram 1 illustrates the transfer pricing audit process in Korea. The first process of the audit entails the selection of taxpayers for tax audits. Generally, tax audits are expected in five-year cycle but recently taxpayers have experienced more frequent tax audit cycle. Additionally, taxpayers whose profitability declined significantly are likely to be selected for the tax audits. Korean tax audit guideline stipulates that the duration of a tax audit should be as short as possible, especially for taxpayers with revenues less than KRW10 billion, the audit should be completed within 20 days from the commencement date. During the tax audit, transfer pricing issues are reviewed by the Transfer Pricing Review Committee (TPRC) before any tax assessments are determined and delivered to the taxpayer. TPRC is required to review transfer pricing adjustments over KRW5 billion, adjustments disapproved by taxpayers, or any other issues as determined by the TPRC. The purpose of the TPRC is to ensure that the proposed transfer pricing adjustments are reviewed by transfer pricing specialists before the completion of a tax audit. After receiving tax assessments, taxpayers can accept the assessments, pursue an appeal in court, or request for mutual agreement procedure (MAP).

Taxpayers who want to pursue an appeal in Korea have the alternatives listed in Table 1.

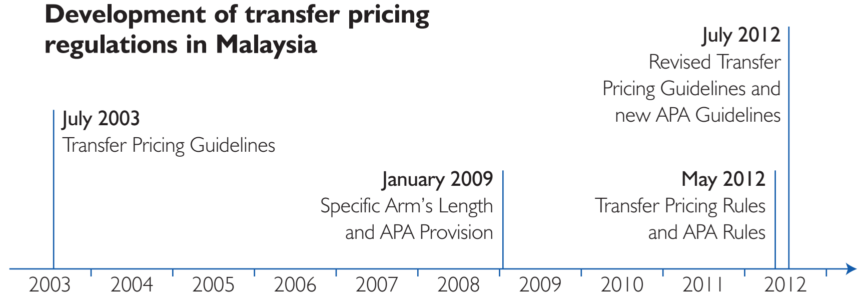
Generally, transfer pricing disputes are resolved through MAP and the taxpayer may request for a suspension of tax payment resulting from the transfer pricing disputes until it is resolved by the competent authorities.

Malaysia's evolving transfer pricing landscape

Bob Kee and Mei Seen Chang of KPMG in Malaysia look at how the transfer pricing landscape is changing.

The transfer pricing landscape in Malaysia continues to evolve with the Malaysian tax authority becoming increasingly proactive and vigilant in scrutinising the controlled transactions of multinational enterprises (MNEs). The intensity of tax audits has certainly increased and the Malaysian tax authority has been rather successful.

Development of transfer pricing regulations in Malaysia



With the release of a new set of rules and guidelines, as expected, there was a substantial increase in TP audit activities carried out by the Malaysian tax authority in recent years. The Malaysian Inland Revenue Board (MIRB) has been efficient and systematic in redeploying resources to ensure compliance in this area of taxation, often taking aggressive stance in protecting their claims to taxable profits.

Dealing with TP rules and regulations

The Transfer Pricing Rules (TPG 2012) specify the responsibilities of taxpayers regarding TP compliance and also highlight the need to prepare contemporaneous TP documentation to prove that transactions with associated persons are at arm's length. The TPG 2012 sets out thresholds to ease the compliance burden of taxpayers with low levels of controlled transactions and allow them to opt to prepare a limited scope TP documentation. The full scope documentation is needed for taxpayers meeting the following requirements:

- Minimum gross income of MYR25 million ($7.6 million) and total amount of controlled transactions exceeding MYR15 million; or
- Provision of financial assistance where the value is in excess of MYR50 million.

Taxpayers that fall below these thresholds would still need to comply with the arm's length provision, but they may opt to prepare limited scope TP documentation. Nonetheless, the MIRB still encourages taxpayers falling below the threshold to comply fully with the guidelines.

Biography

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Bob is currently KPMG's transfer pricing leader and a member of the KPMG GST strategic team in Malaysia.

Bob advises on transfer pricing issues, including formulating defense strategies for tax audit situations and planning for transfer pricing risk mitigation, as well as transfer pricing planning services in relation to the supply chain restructuring of companies operating in various industries.

In 2011, Bob earned the distinction of being the first expert witness in Malaysia's first transfer pricing court case.

Bob is also experienced in indirect taxes and GST. His experience in transfer pricing and also customs' valuation rules enables him to provide sound transfer pricing planning and advice from both a direct and indirect tax perspective.

Having said this, TP documentation is not required to be submitted with the annual tax return although there are suggestions that a disclosure regarding the preparation of TP documentation would need to be made in the tax return in the near future. The documentation needs to be submitted to the MIRB only upon request (usually within 30 days).

It is also worth considering some of the pertinent MIRB practices as clarified in the TPG 2012/TP Rules (2012):

- The TPG 2012 emphasises that a year-by-year comparison must be carried out when conducting benchmarking analyses, that is, the results of the controlled transaction are to be compared with the results of an uncontrolled transaction for the same basis year. The use of multi-year data is intended to identify whether the outcome of a particular year is influenced by abnormal factors. In practice, the median of the inter-quartile range is often used as the starting point when reviewing arm's-length pricing.
- The TPG 2012 states that the MIRB prefers using local companies as comparables in a benchmarking analysis because of the availability of sufficient and verifiable information. Unless it can be proven to the MIRB that there are no good-quality local comparables, foreign comparables are normally not acceptable. Taxpayers who are using regional-based documentation should consider supplementing the regional comparability analysis with a local benchmarking analysis, to the extent relevant, to have the additional comfort that their related party transactions are arm's length from a Malaysian TP perspective.
- Other than the typical TP documentation requirements as set out in the TPG 2012, the documentation requirements would be more onerous for specific transactions such as intra-group services, intangible property, cost contribution arrangements and intra-group financing. In order to address these issues in the Malaysian context, it is worthwhile to study them as these are also areas which are hotly debated during TP audits by the MIRB.

Enhanced transfer pricing compliance through desk audit

The MIRB has introduced a form — Form MNE [1/2012] — to collect certain information from selected taxpayers relating to their cross-border transactions. The form is modified for local related party transactions – Form JCK. The data collected through this form will enable the MIRB to assess taxpayers' TP risk. Presumably, those taxpayers that are considered high risk by the MIRB will be prioritised for a TP audit. It would not be unreasonable to expect that multinational companies with significant related party transactions and local groups with operations overseas would be targeted.

Other than targeting taxpayers through the Form MNE/JCK, the routine request for information for MIRB's desk audit is also carried out. In recent months, we have seen a significant increase in the number of taxpayers who are targeted for desk audits.

Transfer pricing audit framework

In line with the aim to provide further clarification on TP matters, the MIRB has released the TP audit framework to provide clarity and guidance on how TP audits would be carried out (effective from April 1 2013).

The new penalty framework is definitely a welcome move as the MIRB has officially acknowledged that good quality contemporaneous TP documentation can penalty protect the taxpayer. The MIRB has now introduced a new penalty regime in which a concession is given to taxpayers who opt for voluntary disclosure.

Against the backdrop of increased TP scrutiny, the number of tax disputes has risen and one taxpayer has appealed to the Special Commissioners of Income Tax (SCIT). This was the first TP court case in Malaysia and was heard at the SCIT over a two year period.

First transfer pricing case heard in the Malaysian Tax Court

Background

In August 2010, the first TP case was heard at the SCIT. A judgment in this first and only TP matter to face a Malaysian

Table 1

Facts of the case	MIRB's contention	Taxpayer's defence
Issue 1: Commission rate		
The taxpayer is principally engaged as a Malaysian shipping agent by its principal. Between the financial year 1998 and 2001, the commission rate paid by the principal to the taxpayer had reduced as follows: Reduction in commission rate: Export commission 3.25% → 3.00%; Export commission 1.25% → 1.00% The reduction of the commission rate did not affect the taxpayer from achieving healthy profits as the reduced commission still resulted in an overall arm's length remuneration for the taxpayer based on a local benchmarking analysis prepared by KPMG. The MIRB alleged that the principal should not have reduced the commission income by 0.25% as the functions performed, assets employed and risks assumed (functional profile – FAR) has not changed.	MIRB contended that the FAR did not change, and the MIRB found that the comparable companies recognised different income streams (freight income) as compared to the taxpayer (commission income). Thus, the MIRB concluded that the TP documentation did not substantiate that the transactions were conducted "at arm's-length".	The MIRB did not give other reasons other than stating that the FAR of the taxpayer did not change, hence reduction in commission rate was not warranted. The adjustment by the MIRB was not acceptable as the adjustment of commission rate was a commercial decision and that the FAR had indeed changed as it no longer assumed the risk of the success/failure of the IT development function. The taxpayer also submitted TP documentation to the MIRB to support the arm's length nature of the commission income. Further, the principal also had a third party transaction where the commission paid was in fact lower compared to the commission paid to the taxpayer.
Issue 2: Service fees		
Between the financial year 1999 and 2002, the taxpayer paid service fee to their regional headquarter (HQ) in Singapore for business process improvement services. The taxpayer required the services from the regional HQ to function efficiently as a business organisation within the group. As a multinational company, the taxpayer needed to streamline its business practices to ensure that it was efficient especially in the services, cost and management aspects. Information was provided to the MIRB on several large projects carried out regionally for the benefit of the local operations. There was no duplication of services between those services rendered by the regional HQ and the taxpayer. The MIRB disallowed the service fee charges incurred by the taxpayer by way of a TP adjustment and alleged that the services were not rendered.	During the field audit, MIRB alleged that the taxpayer failed to submit relevant documents to substantiate that the services were rendered. The service fee payment made to the regional HQ was considered as intra-group service and the taxpayer failed to substantiate the arm's-length nature of the charge.	The MIRB gave various reasons for disallowing the deduction claimed such as arguing that the charges were not at arm's length and then, alleging that services were not rendered. The taxpayer was able to substantiate that services were rendered and the details have been provided to the MIRB during the audit as well as in Court.
Note: The third issue, a non TP related matter, was in respect of the applicability of withholding tax on EDP charges. The MIRB is of the view that the expenses incurred for the EDP services paid constitute to royalty pursuant to Article XII of the relevant double taxation agreement (DTA). This issue is not elaborated in this article.		

court was handed down by the SCIT in June 2012. KPMG acted as a Professional Witness in this case. The SCIT found in favour of the taxpayer. This case is currently under appeal by the MIRB to the High Court.

Table 1 shows the controlled transactions challenged by the MIRB in which the taxpayer was involved.

Ruling released on November 7 2013

Issue one: Commission Rate

The SCIT accepted the taxpayer's contention and held that:

- Although the comparables did not perform exactly similar functions like the taxpayer, the SCIT still accepted the fact that they performed generally similar functions as the taxpayer.
- The taxpayer's ability to provide the necessary documentation to substantiate the reduction in commission rate showed that the taxpayer had acted in good faith and that the transaction was carried out at arm's-length.

Issue two: Service fees

The SCIT found merits in the taxpayer's documentation and that the services were indeed rendered from the regional HQ.

Our comments

The first TP case in Malaysia has affirmed some very important principles related to the determination of the arm's-length price. It was demonstrated in court that the judges recognise the taxpayer's efforts in preparing TP documentation to substantiate the arm's-length nature of the controlled transactions, hence, showed that the taxpayer had acted in good faith and took the necessary efforts to comply with the law. Also, preparation of a local benchmarking analysis is essential to justify the arm's-length nature of a controlled transaction from a Malaysian TP perspective.

With regards to services transactions, it is important for taxpayers to keep sufficient source documents to evidence that services have indeed been rendered for the relevant years of assessment as well as to demonstrate that the services are not duplicative.

Given these developments, we strongly urge taxpayers with sizeable related party dealings to prepare themselves and have in place contemporaneous TP documentation as a first line of defense in the event of a TP enquiry or audit. Tax audit activities are intensifying and the MIRB has plans underway to further tighten enforcement of TP compliance by Malaysian taxpayers.

Biography

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Mei Seen advises multinational companies on transfer pricing matters, including preparation of transfer pricing documentation in compliance to the Malaysian transfer pricing rules and guidelines, advisory and planning for risk mitigation as well as involvement in dispute resolution on transfer pricing issues. Industry coverage extends to include logistics, pharmaceutical, automotive, insurance, semiconductor, commodities, oil and gas as well as FMCG.

Mei Seen is also actively involved in advance pricing agreement (APA) applications. She was also involved in the first transfer pricing court case in Malaysia.

An election year in New Zealand

Kim Jarrett, Kimberley Bruneau and Kyle Finnerty of KPMG in New Zealand give an overview of New Zealand transfer pricing in a year where change is possible.

New Zealand was a relatively early adopter of the principles of transfer pricing, perhaps in recognition of the unavoidability of cross-border trade for a small country. Nowadays, agricultural exports, including dairy, meat, forestry and seafood products, continue to underpin New Zealand's economy and offshore investment in these sectors is relatively common, reflecting New Zealand's capital markets approach to its economy. New Zealand's economy does however show signs of increased diversification, as the technology sector, including software, electronics and telecommunications technology, grow in importance. New Zealand enjoys moderate economic growth of approximately 2% in annual GDP.

New Zealand's primary trading partner has historically been Australia though strengthening relationships between New Zealand and China (including China's first free trade agreement with any developed country) have led to this Asian powerhouse becoming a main trading partner of New Zealand for both imports and exports.

This year is an election year for New Zealand and a change in government is a possibility. New Zealand is relatively unusual in that it does not have a wide-ranging capital gains tax (CGT); however that may be set to change as the introduction of CGT is flagged to be a key election issue by opposition parties. The introduction of CGT would have flow on implications for transfer pricing, including assets valuations as part of business restructurings. This is an area which warrants monitoring for any multinationals with New Zealand operations which are considering restructuring, even without the added complexities of transfer pricing.

What's the focus?

Unsurprisingly, given New Zealand's geographically isolated location, it is often at the end of the supply chain for multinational enterprises. With that comes a prevalence of intra-group pricing policies whereby the New Zealand entity earns a modest net margin return, and possibly receives funding from offshore, resulting in further interest deductions.

While Inland Revenue continues to review the consistency of the functional profiles of New Zealand entities with low profit margins (that is, questions whether the characterisation of the New Zealand entity as a limited risk distributor appropriate), inter-group financing is the current hot topic in transfer pricing in New Zealand. Indeed, in the cases we are seeing over half the current Inland Revenue's protracted disputes revolve around intercompany financing transactions, including loans, guarantee fees, debt factoring and foreign exchange risk management. We fully expect this focus on financing will persist.

For multinational groups with New Zealand entities having limited risk profiles, interest deductions remain an option for tax efficiently repatriating funds to parent entities. Accordingly, Inland Revenue has a keen eye on ensuring such transactions comply with the arm's-length principle.

Over the past few years, Inland Revenue has invested in developing significant expertise in the field of banking and financing. This has included hiring specialists with extensive experience in financial institutions who accordingly have detailed knowledge of the global credit markets. These skills are evident in the sophisticated technical approach of Inland Revenue to financing transactions, and the robust and thorough analysis required by taxpayers to support such transactions.

For example, for all loans exceeding NZ$10 million (US$8.4 million), Inland Revenue expects taxpayers to utilise credit assessment tools to evaluate the standalone credit rating of the borrowing entity; relying on generic credit rating data for the group or parent entities is strongly rebutted by the tax authority. The credit rating of the parent or group will only be considered by Inland Revenue in the context of determining whether the borrower may benefit from implicit credit support as a result of global affiliations. In our experience Inland Revenue is a strong proponent of notching up the credit rating of the New Zealand borrower where there is evidence of implicit credit support.

Taxpayers are then required to use market data to determine the arm's-length interest rate taking into account the credit rating of the borrower. In doing so the key terms of the loan at the time the loan is put in place need to be considered. In this regard, some taxpayers have contended that, as with commercial lending arrangements between third parties, charges such as commitment fees, line fees, establishment fees and break fees are appropriate. Inland Revenue has indicated that such fees may be valid in some circumstances; however quantification and supplying arm's-length evidence to support the charges remains a challenging area.

For loans of less than NZ$10 million but more than NZ$2 million, Inland Revenue takes a commercial approach and typically accepts a bank quote as reasonable evidence that the interest rate complies with the arm's-length principle. If taxpayers are to rely on such an approach, it is critical that the bank loan quote matches the intra-group funding in terms of all key elements (for example quantum, currency, security, time of drawdown, maturity).

For loans of less than NZ$2 million, or low-value loans as they are colloquially referred to, Inland Revenue has issued a safe harbour, thus recognising that investing significant time in determining the interest rates for these loans is generally unwarranted. Therefore, taxpayers can opt to rely on a safe harbour interest rate comprising of the relevant base rate plus a margin (set at 275 basis points). The margin is periodically revisited by Inland Revenue in reflection of capital market trends.

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Kim heads KPMG's New Zealand transfer pricing and customs practice is also instrumental in the international trade services team.

She is a cross-border tax specialist and has a broad range of general tax, transfer pricing and customs experience. Kim has significant experience advising inbound and outbound clients on transfer pricing and customs issues and assisting New Zealand headquartered clients develop efficient global transfer pricing strategies.

Kim has an excellent reputation for her technical skills, her approach to the management of transfer pricing disputes, and her strong focus on service delivery. She has guided a number of New Zealand based clients investing offshore, including which structure fits the group's operating and commercial structure best.

Kim has the ability to communicate at the highest level, and has direct experience in presenting on transfer pricing matters to directors, senior executives and Inland Revenue.

What about New Zealand headquartered groups?

For multinational groups headquartered in New Zealand, though financing will still be a key focus area in terms of transfer pricing, market support payments should also be on the radar. Market support payments from a New Zealand principal to an overseas group entity are typically deductible for tax purposes but Inland Revenue prefers the payments to be based on specific costs. Documenting the specific costs being reimbursed is therefore critical.

Inland Revenue is also more likely to scrutinise market support payments when they continue over an extended period of time. This is because of the expectation on the part of Inland Revenue that in the longer term the overseas entity would become profitable or the New Zealand parent would decide not to pursue the market opportunity.

Dealing with Inland Revenue

For many multinationals, the size of New Zealand operations is modest relative to the group's activities in other locations. From a New Zealand perspective, however, the domestic

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Kimberley is a senior manager in KPMG's New Zealand transfer pricing team.

Kimberley commenced her career with KPMG New Zealand in 2004 in the tax division where she provided assistance with corporate tax, transfer pricing and customs. In this role she built a strong foundation from which to advise clients on the broader tax implications of transfer pricing strategies.

Kimberley spent three years with KPMG Hong Kong as part of the Asia Pacific regional transfer pricing team. There she was heavily involved in transfer pricing projects with a regional or global focus, including those establishing and defending group-wide transfer pricing strategies. In this role she gained exposure to the diverse spectrum of tax authority approaches to transfer pricing, and developed a commercial approach to intra-group pricing.

Kimberley now leverages her international experience in the international trade service team and assists New Zealand companies looking to expand into the global market.

activities of the multinational can be significant, and very visible to Inland Revenue. Tax directors therefore would be well advised to take into consideration the relative size of the New Zealand economy when deciding what transactions to document from a transfer pricing perspective, as well as being open to dealing with Inland Revenue. As an indication of the quantum of transactions attracting Inland Revenue attention, New Zealand's safe harbour for intercompany loans only applies to loans of less than NZ$2 million (US$1.6 million).

The New Zealand Inland Revenue formally adopted the arm's-length principle in 1996 and has since developed significant technical expertise in the field of transfer pricing. This is clearly evident in the sophisticated, yet generally commercial, approaches taken by the tax authority in their interactions with taxpayers in relation to transfer pricing. In this regard, Inland Revenue nowadays places greater emphasis on the OECD Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises (OECD Guidelines) vis-a-vis the formal New Zealand transfer pricing guidelines which it released in 2000.

Biography

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Kyle has been with KPMG since 2006 and part of KPMG's transfer pricing practice in Canada and now New Zealand since 2011. Kyle is a Canadian Chartered Professional Accountant and has worked in the transfer pricing, auditing and IES practices during his tenure at KPMG. The experience he has gained from the diverse range of disciplines allows him to bring a broader international trade services perspective of business understanding when advising clients on transfer pricing issues.

Kyle has provided transfer pricing advice on a variety of topics from guarantee fees to management fees, for most industries such as pharmaceutical, energy and technology.

As part of KPMG Canada's transfer pricing team, Kyle specialised in dispute resolution with experience in taxation authority audits, preparing notices of objection and competent authority requests.

On KPMG New Zealand's transfer pricing team, Kyle specialises in interest rate benchmarking for related party cross-border loans.

For many taxpayers, the receipt of a transfer pricing questionnaire will be the starting point for interactions with Inland Revenue in relation to their cross-border intercompany transactions. This questionnaire continues to be used by Inland Revenue as a risk assessment tool and is therefore designed to gather high-level information on factors such as the nature, quantum and pricing methodologies for related party transactions. Areas such as the activities and level of debt of the New Zealand entity relative to those of the group are also covered by the questionnaire.

The transfer pricing questionnaire includes a question as to whether transfer pricing documentation has been prepared to support the taxpayer's transfer prices in accordance with New Zealand transfer pricing guidelines. While at present there are no technical contemporaneous documentation requirements in New Zealand there is a practical requirement to have documentation in place from a compliance perspective. Specifically, New Zealand's legislation requires that a transfer pricing method is applied, which in practice must be evidenced through documentation. Therefore, responding in the negative to this question usually results in additional enquiries from Inland Revenue.

While Inland Revenue may issue a transfer pricing questionnaire independently of other enquiries, more commonly it arises as part of a general tax review or audit.

What's on the horizon?

Inland Revenue has publicly endorsed the work of the OECD on base erosion and profit shifting (BEPS). New Zealand is an active participant at discussions regarding BEPS and has signalled that it will take a principled and co-operative approach to the recommendations of the OECD around this global focus.

Of those areas under consideration as part of BEPS, those relating to the disclosure of information and the digital economy may have the greatest implications for New Zealand taxpayers. To date, Inland Revenue has taken a practical, risk-based approach to gathering information from taxpayers on cross-border related party transactions. However, depending on the recommendations of the OECD around country-by-country reporting and the response from Inland Revenue, taxpayers may find themselves needing to revisit and extend their transfer pricing documentation approach. In response to this, some taxpayers are anticipating changes and restructuring their existing documentation to adopt a master file and country appendices structure.

Digital economy developments are important from a New Zealand perspective as New Zealanders purchase significant quantities of goods via the internet. These transactions are already on Inland Revenue's radar as they have revenue collection implications in terms of GST.

Looking forward, practical challenges remain for taxpayers importing goods into New Zealand which have been purchased from related parties. Legislative hurdles exist from a New Zealand Customs' perspective to using transfer pricing documentation to support the valuation of imported goods and, in many instances, customs and transfer pricing valuation methodologies lead to different results. While Inland Revenue and the New Zealand Customs Service are actively exploring options to alleviate the current difficulties, a resolution is not anticipated in the immediate future.

Managing transfer pricing risks in New Zealand

While Inland Revenue's standard of technical analysis is extremely robust, communications between the Inland Revenue and taxpayers are generally less adversarial than may be expected by taxpayers who are used to dealing with the authorities in jurisdictions such as Canada and Australia. Inland Revenue promotes full disclosure of information, frank dialogue and is typically commercial in its approach to transfer pricing. Therefore, when entering into discussions with Inland Revenue, taxpayers would be advised to approach the process with a cooperative mindset. Creating the impression that a taxpayer is hindering the provision of information or is stalling for time can have particularly negative consequences.

The prevalence of unilateral advance pricing agreements (APAs) as a mechanism for minimising compliance costs and resolving transfer pricing audits is perhaps higher than in most other jurisdictions globally. Therefore, for taxpayers looking for certainty around transfer pricing within a purely domestic New Zealand context, a unilateral APA is likely to be an attractive option. On a practical level, in our experience Inland Revenue has a highly cooperative attitude to taxpayers which proactively approach the tax authority.

At an Inland Revenue policy level, APAs are strongly supported and encouraged for taxpayers and, accordingly, Inland Revenue has set itself ambitious target timeframes for concluding agreements. Encouragingly the timeframes, such as six months for a unilateral APA, are usually achieved. Further, Inland Revenue has publicly stated that they will support taxpayers in a mutual agreement procedure (MAP) if the taxpayer has previously entered into a unilateral APA with Inland Revenue in relation to the contended transaction.

One-year review of new Philippine TP regulations

Maria Carmela Peralta, Eugene Pulga, Rey Llesol and Valerie Jill Reyes of KPMG in the Philippines take a look at the first year of the new transfer pricing regulations.

With the advent of the transfer pricing regulations – Revenue Regulations No. 02-2013, dated January 23 2013 (RR No. 02-2013) – which took effect on February 9 2013, taxpayers expected the Philippine Bureau of Internal Revenue (BIR) to take action on transfer pricing matters. To date, however, the BIR has apparently kept away from undertaking any enforcement measure. Despite the numerous queries from the public on the matter, it also has not issued circulars to provide guidelines in implementing RR No. 02-2013. Further, the BIR is not entertaining applications for advance pricing agreements (APAs) and the availment of the mutual agreement procedure (MAP) found under tax treaties.

Trends / focus areas of the BIR

To say that the BIR is not taking action might be premature. It is known to the public that certain personnel of the BIR have been attending training sessions outside the country on transfer pricing.

Further, recent issuances suggest that at this stage, the BIR has started to develop a database on taxpayers. The BIR's Revenue Memorandum Order No. 02-2014 (RMO No. 02-2014), dated January 8 2014, provides for a revised manner of classifying taxpayers and prescribes the use of the latest Philippine Standard Industrial Classification (PSIC) in the classification. One of the objectives of RMO No. 02-2014 is to generate more accurate statistics.

More importantly, Revenue Regulations No. 02-2014, dated January 24 2014, issued by the Secretary of Finance, prescribes the use of new forms for the filing of the annual income tax returns starting with taxable year ended December 31 2013. The new forms include a portion for corporate taxpayers to enumerate their top 20 stockholders and to state their taxpayer's identification numbers, capital contribution, and percentages of ownership. These new forms also require the corporations' PSIC codes to be stated.

These issuances will enable the BIR to collect relevant information on taxpayers and, consequently, to make transfer pricing risk assessments of taxpayers and select taxpayers for transfer pricing audits.

Taxpayers may have to carefully review the information to be stated in their annual income tax returns as well as re-visit the information previously submitted to the BIR.

Taxpayers' concerns

Notwithstanding the absence of guidelines on the implementation of RR No. 02-2013, taxpayers have started to comply with the regulations' documentation requirements. In performing the transfer pricing studies, taxpayers can rely on the OECD

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transfer pricing guidelines after which RR No. 02-2013 has been patterned. Most concerned in complying with the documentation requirements are taxpayers with significant cross-border transactions or taxpayers registered with investment promotion agencies and enjoying tax incentives. After-all, based on the language of RR No. 02-2013, these taxpayers seem to be the priority for any transfer pricing scrutiny.

But perhaps the application in the Philippines of transfer pricing rules may have its own peculiarities in view of the maturity level and appreciation by all parties concerned.

Local comparables

One concern is on whether to use local comparables or regional comparables. Taxpayers may have initially perceived RR No. 02-2013 to require the use of local comparables. They have, therefore, insisted on searching for local comparables. Since the Philippines still does not have a local database suited for transfer pricing studies, they have manually checked the audited financial statements filed by Philippine corporations with the Philippine Securities and Exchange Commission (SEC).

However, the challenge has been to ensure the quality of data and the sufficiency of the number of comparables. Uncertainty in the treatment in the audited financial statements of certain items of income and expense and other balance sheet items and insufficient disclosures in the notes could affect the quality of the data. This is true even in other tax jurisdictions.

But another factor will be the timing of the local comparable search. Almost all of the Philippine corporations have a calendar year-end and are, thus, required to file with the SEC their audited financial statements no later than 31 May of the following year. A study done for planning/setting purposes for the year ended 31 December 2013 would have likely used 2012 figures only if the study was done after May 31 2013; otherwise, 2011 figures would have been the most recent data.

Further, corporations seemingly do not regularly file consolidated financial statements with the SEC, which are normally used for transfer pricing studies in other tax jurisdictions. The lack of the consolidated financial statements could affect the results of the studies.

Certain reasons could, however, necessitate the use of local comparables. For example, since RR No. 02-2013 applies to local transactions as well, the use of local comparables might make sense for such transactions. In case where a local comparable search is conducted, taxpayers have to ensure the approach taken for the local search to be consis-

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tent with the approach mandated by the OECD transfer pricing guidelines.

Year-end adjustments

Taxpayers have found that making year-end adjustments could be very difficult because they do not have answers from the BIR to their questions such as the timing of and the support for the adjustments.

In the absence of guidelines, it may be advisable for taxpayers to consider first the type of related-party transactions to be affected by the proposed adjustments. Is it a sale of goods or purchase of goods? Is it a sale of services or purchase of services? The adjustments may have a significant impact on withholding taxes, value-added taxes, and customs duties.

For example, any adjustments that could require additional payments from a Philippine corporation to an offshore related-party for purchase of services could involve additional withholding tax liabilities maybe at the rates provided under the Philippine tax laws. Tax treaty relief might no longer be available.

Adjustments on the purchase price of imported goods for a local distributor, for example, could impact on the distributor's compliance with the customs laws. Add to this is the fact that in non-transfer pricing audits, the BIR could compare the purchase amounts reflected in the tax returns/financial statements to those generated from declarations made with the customs authorities. Any discrepancy could lead the BIR to impose deficiency taxes.

Taxpayers also have to check the substantiation to effect the adjustments not only for transfer pricing purposes but for financial accounting purposes as well.

During the income tax holiday

As mentioned-above, taxpayers registered with investment promotion agencies and enjoying tax incentives could be the main target for transfer pricing scrutiny.

It is possible that while a taxpayer is enjoying the income tax holiday (ITH) incentive and is exempted from the 30% regular corporate income tax for a certain period, additional tax might be assessed because of transfer pricing adjustments made by the BIR. Since the taxpayer is still liable for the withholding taxes on certain income payments made, the taxpayer may be assessed with deficiency withholding taxes because of transfer pricing adjustments made with respect to the income payments. The withholding tax is considered payment of the income tax due from the payee but collected through the payor as the withholding agent. And the BIR has not yet clarified whether the transfer pricing regulations impact only on a corporation's 30% regular corporate income tax liability or also on its withholding tax liability.

Taxpayers may also have to check the materiality of their income payments and consider the transfer pricing issues of these payments.

Strategy / planning

With the very basic transfer pricing regulations and in the absence of the MAP and APA framework, taxpayers are challenged to spot opportunities to minimize transfer pricing risks or at least the compliance costs not only for transfer pricing purposes but for regular tax audits.

Newly-set up shared services centres

Newly-established shared services centers availing of the ITH should still consider preparing transfer pricing studies for the shared services. It appears that the need becomes more urgent when migration costs they will incur are substantial only during the ITH period. While transfer pricing studies could support the mark-up adopted during the subsequent years after the ITH period, the BIR during regular audits could take note of the substantial revenues reported during the ITH period as stated in absolute amounts. A substantial decrease in revenues will be a red flag for audit.

In addition, certain items to be considered in coming up with the search strategy (for example plant, property, equipment – net) may vary significantly from year to year during the early part of a corporation's life as the corporation is in the process of growing/maximising its operations. It is advisable to consider projections for the next four or five years to plan when a full-blown study or an update is required.

Tie-up with other tax rules

In determining how to prioritise compliance with the documentation requirements of RR No. 02-2013, one should consider also other tax rules. Recently, the BIR has disallowed the subcontract costs as a deduction for purposes of computing the 5% preferential tax rate being enjoyed by export enterprises registered with the Philippine Economic Zone Authority (PEZA). Foreign investors with an intention to set up wholly-owned subsidiaries to be registered with PEZA may have to consider this in structuring their Philippine operations and avoid subcontracting a portion of their operations even to related parties. In this way, they could minimise their subcontract costs and maximise the availment of the 5% preferential tax rate.

Intercompany advances

A recent Supreme Court decision has stated that the BIR cannot impute interest income for non-interest bearing intercompany advances. The reason for the non-imputation is based on the provision in the Civil Code that no interest shall be due unless it has been expressly stipulated in writing. It appears that the BIR has accepted this decision as there have been no other instances yet when the BIR acted in a contrary manner.

Taxpayers could use this decision as a basis for not charging interest for intercompany advances or for prioritising other related-party transactions for the preparation of the transfer pricing documentation.

However, taxpayers may have to consider also the transfer pricing rules affecting the offshore related parties involved in these intercompany advances.

Timing for preparation

RR No. 02-2013 does not impose penalties for the mere failure to prepare the documentation. However, it requires the documentation to be contemporaneous. It also mandates taxpayers to submit to the BIR the documentation when required or requested to do so. Taxpayers preparing the documentation on a timely basis will be able to manage the increasingly strict procedural requirements of the BIR in conducting tax audits. Existing rules for regular tax audits will most likely apply to transfer pricing audits. Recent amendments introduced to the BIR rules for handling tax audits have somehow shortened the time allowed for taxpayers to submit documents or prepare their defenses. Having contemporaneous documentation will assist taxpayers in meeting the time limits for submission of documentation and strengthen the defense of their transfer pricing analysis.

Being mindful

While taxpayers await the BIR's issuance of additional guidelines for implementing the transfer pricing regulations, taxpayers should be mindful of the documentation and other requirements under the regulations. Taxpayers will be able to anticipate the transfer pricing concerns that might impact them and perhaps more properly and proactively handle these concerns even before the BIR starts its transfer pricing audits.

Transfer pricing in Singapore: A review and update

Geoffrey Soh and Felicia Chia of KPMG in Singapore summarise the transfer pricing developments in Singapore and provide their thoughts on what the future may entail.

Given Singapore's pro-business policies and relatively low tax rate, some multinationals have the perception that transfer pricing should not be an area of concern for its Singapore operations. Despite this notion, the reality is quite different. Over the past few years, the Inland Revenue Authority of Singapore (IRAS) has increased its focus on transfer pricing and companies have been subject to transfer pricing consultation and audit. Some of these have resulted in upward adjustments to income, additional tax, and in some instances, even penalties.

Singapore transfer pricing framework

In February 2006, IRAS released a circular on the concepts and application of transfer pricing (2006 Circular). The circular echoes the OECD transfer pricing guidance of that time, albeit with a few differences (such as the best method concept). Over the course of the next four years, other transfer pricing-related circulars followed, as well as formal legislation of the arm's-length principle into the Singapore Income Tax Act. We have summarised all of these items below:

- 2006 – Transfer Pricing Guidelines;
- 2008 – Transfer Pricing Consultation;
- 2008 – Supplementary Administrative Guidance on APA;
- 2009 – Transfer Pricing Guidelines for Related-Party Loans and Related-Party Services; and
- 2010 – Amendment in the Singapore Income Tax Act with respect to the arm's-length principle (Section 34(D) – Transactions Not At Arm's-Length).

The transfer pricing guidance in the 2006 Circular is applicable to all related-party transactions – between two Singapore parties or between a Singapore party and an offshore counterparty. It is equally applicable to legal entities and/or permanent establishments, such as branches. There are no official volume or dollar thresholds, under which transfer pricing or documentation is not applicable.

Although there are no formal requirements to file documentation, it is IRAS' expectation that taxpayers exert reasonable efforts to undertake a sound transfer pricing analysis, to demonstrate that the related-party transactions are conducted at arm's-length. When reasonable efforts have been exercised, the transfer prices would be considered, prima facie, as arm's-length. Accordingly the burden of proof would then reside with IRAS. Adequate and timely documentation will go towards demonstrating a reasonable effort. IRAS warns that scant documentation for significant or complex transactions may result in reviews and challenges.

Increasing transfer pricing queries in Singapore

After the release of the 2006 Circular, IRAS seemed to have allowed a grace period for taxpayers to adapt and comply with the new transfer pricing rules. Consequently, there is no discernible difference in their transfer pricing audit focus before and after.

The landscape started to change in mid 2008, when IRAS released the Consultation Circular (2008 Circular). This Circular aims to foster taxpayers' transfer pricing awareness and compliance through taxpayer to tax authority consultations (hence its name), and to emphasise the importance of transfer pricing documentation. In selecting candidates for the transfer pricing consultation process, IRAS uses analytics to highlight companies that may be high risk or behind the curve on transfer pricing compliance. Based on anecdotal observations, commodity trading companies, perhaps because of their low margin-high volume business model, were the first batch selected for consultation. This was followed by a more diverse set of companies in the distribution, chip fabrication, and electronics manufacturing industries. More recently, service companies and companies in the financial service industry have also been under scrutiny.

IRAS' first step in the consultation process is to send out transfer pricing questionnaires to assess the taxpayer's transfer pricing compliance. These questionnaires are usually quite lengthy (about seven to eight pages), with detailed questions on transfer pricing arrangements, business operations, financials, and availability of supporting documentation. Depending on the response received, IRAS may initiate further rounds of questioning and even embark on a field visit to the taxpayer. At the end of the process, IRAS will provide the taxpayer with its opinion of the taxpayer's transfer pricing approach and documentation. If the taxpayer's transfer pricing deviates from IRAS' opinion of arm's-length pricing, it is possible that there will be an upward adjustment to income and additional taxes. Further, IRAS has the power to impose penalties from 100% of the tax undercharged (for an incorrect return) to 400% of the tax undercharged (for serious fraudulent tax evasion). However, in practice, penalties arising from transfer pricing controversy are relatively infrequent.

Outside of the foregoing approach, corporate tax auditors in IRAS have also been increasingly raising transfer pricing questions as part of their routine corporate tax query process and audits. It is not uncommon for corporate tax queries to contain questions asking taxpayers to prove that a certain related-party transaction is conducted in an arm's-length manner. This again highlights the importance of having a sound transfer pricing analysis, to provide a meaningful response should the need suddenly arises.

A common red flag may be where the company shows persistent losses or low profitability, especially if most of the transactions are with related parties. It is the perception of IRAS (and many other tax authorities) that losses, especially those which persistent for a number of years, are unlikely to be consistent with arm's-length behaviour. However, it may be these losses are the result of the group's commercial policy – that because of factors which are non-transfer pricing related. For example, a market penetration strategy, initial teething problems and other start-up costs and industry downturn. In our experience, IRAS can be receptive to such economic arguments, assuming sufficient evidence is assembled to demonstrate what an independent company would have done or achieved in such circumstances.

The payment and receipt of management fees or intra-group service fees also continue to be an area of focus for IRAS. For inbound management fee expenses, the most common concerns raised are:

- Whether the company would purchase the services if it was obliged to obtain them from an unrelated party; if the services in question do not add commercial or economic value to the business, IRAS may argue a tax deduction is not appropriate; and
- If the benefit of services can be substantiated, then the next consideration is whether the fees itself are priced at arm's-length.

For outbound management fee revenue, the focus is mainly on the second point. Where a cost based approach is used

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Geoff has managed more than 800 international transfer pricing engagements. His projects have encompassed the transfer pricing compliance, tax planning, audit defense, and alternative dispute resolution aspects of transfer pricing. He has been involved in MAPs and APAs involving tax authorities from a number of countries.

Geoff has presented at a number of regional transfer pricing conferences and has published articles on Singapore and Canadian transfer pricing developments. He has been cited by *International Tax Review's World Tax* guide for transfer pricing in Singapore.

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Felicia has written a number of articles and is a frequent speaker on transfer pricing matters.

in determining the management fees, the adequacy of the cost base and the arm's-length nature of the mark-up (especially where the IRAS safe harbour for routine support services may not be applicable) are key items which typically scrutinised.

Alternative dispute resolution

IRAS provides support for controversy avoidance and risk management through mutual agreement procedures (MAPs) and advance pricing agreements (APAs). Singapore has an extensive double tax treaty network which allows for these mutual proceedings in more than 70 countries. Hence, relative to the size of its corporate taxpayers, IRAS has processed a good number of MAPs and APAs. As of March 31 2013, IRAS has 13 MAPs at different stages of review, and 38 ongoing APAs.

Whilst MAPs are more a reactive approach to situations where transfer pricing adjustments have already been made in the counterparty's jurisdiction, APAs are an increasingly popular companies for taxpayers in Singapore to proactively reduce tax uncertainty for their intercompany transactions, especially if they assess their transfer pricing risk as high. Because of the relatively low tax rate, many companies have structured their operations such that profits would flow to Singapore (although typically this is backed with evidence of substance and value created by the functions performed, risks assumed and assets borne by the Singapore entity). Bilateral APAs have been used in such instances to protect income in Singapore. While increased time and resources are required to support an APA application, if the amount of effort required is incremental to the effort that may be required to defend a transfer pricing audit, an APA would be a better route. As a result of these efforts, the company would be able to gain certainty over the uncertainty that exists in transfer pricing.

On the horizon

It has been more than eight years since Singapore first introduced transfer pricing guidelines and almost five years since the last transfer pricing circular has been issued. During this eight-year period, there have been many international developments on transfer pricing, including expansions to the original OECD transfer pricing guidelines, and OECD papers (some of which are still in draft form) on the attribution of profits to permanent establishments, business restructuring, documentation, country-by-country reporting, and intangibles. In addition there are five action items on the OECD Base Erosion and Profit Shifting Action Plan which are specific to transfer pricing. Given the foregoing, there is some speculation that IRAS guidance will need to keep pace. Accordingly, it is possible that updated and expanded transfer pricing guidance or requirements may be in the pipeline, to encourage documentation and good transfer pricing practices.

Challenges and opportunities from TP perspectives

Sherry Chang, Karl Chan, Anita Lin and Amber Lee of KPMG in Taiwan trace the trends in Taiwanese transfer pricing.

In the past two to three years, several measures have been taken by Taiwan tax authorities to enhance the effectiveness and efficiency of transfer pricing (TP) audit. On the other hand, intensive discussions have been undertaken between the governments of Taiwan and China to develop possible solutions for mitigating cross-strait double taxation with significant progress likely to be achieved in the near future. The enforcement trends and key focus areas, as well as the development in cross-strait taxation as described below will have significant impact on multinational enterprises having material controlled transactions involving Taiwan.

Enforcement trends

Creation of specialised transfer pricing taskforce in Taipei and Northern Taiwan region

Recently, the taxation bureaus in Taipei and northern Taiwan have set up a specialised TP teams respectively. Although how these specialised TP teams will operate remains unclear at this moment, based on our preliminary understanding, their mission will at least cover the following:

- In charge of negotiation of advance pricing arrangements (APAs);
- Selection of TP focused audit targets; and
- Conduct TP focused audit.

Centralising the above-mentioned work at these specialised TP focus teams will be helpful for expediting the accumulation of TP audit experiences and enhancement of technical knowledge/skills within the tax authorities. It is foreseeable that the enforcement of TP audit in Taipei and northern Taiwan region will be intensified significantly and more and more in-depth, and the processing time for APAs negotiation could be shortened going forward.

Intensification of the application of transaction-by-transaction approach in evaluating arm's-length nature of controlled transactions

The TP regulations specifically provide, unless in situations where an inter-relationship and continuity exist between different controlled transactions, that the arm's-length nature of these transactions should be evaluated on transaction-by-transaction basis. Nevertheless, quite a few taxpayers tend to bundle different transactions together in conducting TP analysis based on certain considerations or because of availability of information from associated enterprises. This is particularly the case for Taiwan subsidiaries of foreign-headquartered multinational enterprises (MNEs). Aiming at intensifying the application of transaction-by-transaction approach in evaluating the arm's-length nature achieved by each controlled transaction, the National Taxation Bureau of Taipei developed a very detailed inspection form to provide guidance to tax officers in review of TP documentation reports prepared by taxpayers for tax year 2011. To complete the inspection form, tax officers started requesting taxpayers to re-perform economic analysis on transaction-by-transaction basis for bundled transactions. The inspection form has been proven to be a highly effective vehicle for increasing revenue resulting from TP adjustments and has been circulated to all taxation bureaus for reference. This development has significant impact on taxpayers not only from increase in compliance costs but also TP adjustment exposure, given different conclusions could be achieved under the transaction-by-transaction approach.

Stricter criterion adopted for selection of profit-level-indicator in applying transactional profits methods

Selection of profit-level-indicator (PLI) might also have significant impact on the conclusion achieved by a benchmarking study performed for specific related-party transactions. Recently, Taiwan tax authorities have incorporated their internal standard procedures and an additional criterion for examining the selection of PLI under transactional profits methods. The new criterion requires the tax officer to reject conclusion achieved by transactional profits method based TP analyses provided the denominator of the PLI selected contain results achieved by controlled transactions.

An unintended effect of the above criterion is the acceptability of Berry ratio to the tax authorities in evaluating the profitability achieved by foreign invested companies mainly acting as a procurement centers or acting as the middle party in a controlled sandwich transaction (purchase from affiliated suppliers followed by sell to affiliated customers). The application of Berry ratio to low-risk buy-sell distributors has been intensively debated between the tax authorities and taxpayers in situations where the return on sales (ROS) achieved by the tested party falls outside the arms-length range. This situation may change because of adoption of the criterion mentioned above because the denominator of the Berry ratio is less likely to contain results achieved by controlled transactions.

Tax authorities' focus areas

Taiwan tax authorities' major focus areas for TP audits include the followings:

Intra-group funding arrangement

Intra-group funding arrangements are more and more common within global MNEs because of the credit crunch resulting from global financial crisis, and have gained increasing attention from the tax authorities in recent years.

Cash-pooling arrangement is a cash management tool frequently adopted by foreign-headquartered MNEs, and is a topic of interest to the tax authorities. Taiwan tax authorities tends to raise TP issues against taxpayers involved in cash-pooling arrangements and constantly maintaining excessive cash position in cash pool abroad. This is particularly the case when the cash pool is situated in a jurisdiction with relatively low market interest rate. In the absence of a robust TP study, the tax authorities may make TP adjustments based on local market interest rates. In the worst situation, the tax authorities could even argue maintaining excessive cash position in the pool should be regarded as lending, and make adjustment based on much higher lending based interest rates.

In addition, intra-group guarantee arrangements are one of the most popular means preferred by Taiwan-based MNEs in funding their associated enterprises abroad, and has become a constant and key focus of TP audits since the introduction of Taiwan TP regulations in 2004. Whether guarantee fees should be charged by the guarantor to the guarantee is a sophisticated TP issue. Generally speaking, guarantee fees should be charged by the guarantor to the guarantee because the guarantor indeed has been exposed to financial risk arising from default of the guarantee and; the guarantee generally has received economic benefits from the guarantee arrangement through saving of funding cost or accessing loan capital originally not available from financial institutions. Based on our experience, credit spread method and comparable uncontrolled price method (CUP) are the two methodologies most commonly acceptable to the Taiwan tax authorities for substantiating the arm's-length nature of intra-group guarantee arrangements.

From corporate finance perspectives, provision of guarantees by a parent company to facilitate its subsidiaries to raise money at lower cost might create financial synergy for both parties. Providing guarantee to a subsidiary could be a better choice for a parent company than either equity or loan capital injection. That is to say, the guarantor might choose to fund its subsidiary with guarantee based on genuine business considerations. A parent providing guarantee to its subsidiary is unlikely to be exposed to higher risk than injecting equity capital to fund the subsidiary. Based on the above, the guarantor might argue that no compensation should be charged for guarantee provided to its subsidiaries, and up to 2012, such arguments had been accepted by quite a few tax inspectors.

However, in recent cases, the position taken by the tax authorities generally is a guarantor must be compensated with arm's-length guarantee fees. In situations where no supporting documents could be provided, the tax authorities generally will make adjustment based on the charging policy adopted by small and medium enterprise (SME) credit guarantee fund of Taiwan (SMEG) for provision of credit guarantee to SMEs. The prevailing range of credit guarantee fee charged by SMEG is between 0.5% and 1.5%.

Intangible property

Taiwan tax authorities' interest in intangible property (IP) related transactions is mainly focused on cross-border licensing arrangements. Although marketing intangibles are not a current key focus of the tax authorities, they may challenge the arm's-length nature achieved by inbound trademark licensing arrangements entered into between local distributors of

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consumption products (for example marketing distributors for sports products and luxury goods) and their foreign associated enterprises, particularly if either of the following conditions are satisfied:

- The local entity continuously makes significant investment on marketing and advertising activities; or
- The products enjoy leading position in local market.

Comparison between the profitability achieved by the licensor and the licensee generally is the starting point for identifying possible audit targets. On the other hand, audits could be triggered by the application filed for refund of tax levied on outward payments for license or transfer of IPs. Different TP methodologies are preferred by the tax authorities based on quality and availability of information related to IP related transactions under review. Conclusion achieved by comparable uncontrolled transaction method (CUT) could be acceptable to tax officers if the issue is raised during the course of general corporate income tax audit (non-TP focused audit). But, in TP-focused audit situations, where the final TP adjustments have to be approved by the Ministry of Finance (MOF), CUT analysis is likely to be rejected by the MOF based on comparability concerns. Based on our experiences, most TP audit on licensing arrangements are closed based on results achieved by transactional profits methods.

Pragmatic strategies for TP documentation

Although the tax authorities emphasise more and more on the application of transaction-by-transaction approach in reviewing transfer pricing documentation reports prepared by taxpayers, they do understand and to certain extent accept the reality that the Taiwan subsidiary of a foreign-headquartered MNE group has very limited access to financials achieved by foreign associated enterprises. In situations where the Taiwan entity is selected as the tested party under a transactional profits method and the profitability achieved by the Taiwan entity is more lucrative than the overall profitability achieved by the group, applying the bundled-transaction approach in preparing the TP study remains a possible and relatively more cost-effective alternative to be considered, particularly when inter-relationship and continuity exist between several controlled transactions. MNEs may consider revisiting the analytical strategies and economic approach adopted for preparing Taiwan TP documentation report in prior years by taking into consideration of the above-mentioned enforcement trends and take actions to counter the possible challenges from the tax officers in the future.

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In terms of cash-pooling and intra-group guarantee arrangements, from a practical and cost-effectiveness perspective, preparation of a CUP-based TP documentation report is recommended. In case no internal CUPs exist, the guarantor in Taiwan may consider either to charge any fees for guarantees provided to foreign associated enterprises or alternatively not to take the time and effort to prepare a TP study and leave this topic as a cushion for negotiation with the tax authorities for a better result based on the following considerations:

- Estimated cost to be incurred for preparing a credit spread method based TP study;
- The amount of TP adjustment to be made by the tax authorities based on the SMEG fee standard; and
- Possible double taxation arising from mismatched tax treatment of guarantee fees between the jurisdiction where the guarantee is situated and Taiwan.

Upcoming development: Cross-strait taxation agreement

The intensification of TP examination in China in recent years and cross-strait double taxation so-triggered has been the major headache of Taiwan companies entering into significant controlled transactions with associated enterprises in China. But a positive development could be expected to alleviate this issue. According to the Finance Minister of Taiwan, the governments of Taiwan and China have reached consensus regarding entering into an OECD model based cross-strait taxation agreement (CSTA) to avoid double taxation and it is expected that the two governments will ink the taxation agreement soon.

MNEs with significant cross-strait controlled transactions should closely monitor the development of the CSTA. It will create an incentive to review cross-strait business models as well as transfer pricing policies to identify possible restructuring opportunities and develop realistic strategies for mitigating transfer pricing exposures more effectively.

Increasing tax collection through TP audits: Be prepared

Benjamas Kullakattimas and Abhisit Pinmaneekul of KPMG in Thailand explain why taxpayers should take an active approach to managing their transfer pricing risks in Thailand.

In preparation for the establishment of the ASEAN Economic Community (AEC) in December 2015 and to increase its competitiveness among other ASEAN countries, Thailand reduced its corporate income tax rate from 30% to 20%. Recently, the Thai government also amended the personal income tax rate, one of the key changes being the reduction of the highest tax rate from 37% to 35% for taxable income of more than Bt4 million ($124,000).

The reduction of the corporate and personal income tax rates, as well as the increase of government expenditure on several large infrastructure projects have caused the Thai Revenue Department (TRD) to start strengthening its tax collection. The Department has realised that government revenue would definitely decline if the TRD were to still use the old-fashioned way to collect tax. In 2013 the TRD disclosed that it plans to adopt the risk management principle, known as the Compliance Risk Management (CRM) as a tool to manage its tax collection. This different audit approach or assessment will be adopted for those in between high and low risk groups, as assessed by the TRD.

In recent years the TRD has also been cooperating with other countries' revenue departments to exchange knowledge in the areas of tax administration and collection. Thailand entered into memoranda of understanding (MoUs) with Korea and Malaysia, respectively, to allow for the exchange of tax officers for training as well as the sharing of issues specifically arising from cross-border transactions. In the realm of taxation of cross-border transactions, transfer pricing is one of the most pressing issues in Thailand at the moment. The Thai tax authorities are conducting transfer pricing audits more aggressively as a way to increase tax collection.

Transfer pricing development in Thailand

Thailand's transfer pricing guidelines were introduced in 2002 when the TRD issued Departmental Instruction No Paw 113/2545 (DI Paw 113/2545) providing guidelines on the transfer pricing methods and the required documentation. Unlike some other ASEAN countries, transfer pricing documentation is still not mandatory in Thailand. Since the introduction of DI Paw 113/2545, no additional guidelines or regulations (other than advance pricing agreements (APAs)) have been formally issued. Rather, the TRD has formulated several internal guidelines through their audits.

However, the Department has recently expressed on several occasions that it intends to introduce tax reforms in these areas:

- Transfer pricing;
- Thin capitalisation;
- Controlled foreign companies; and
- A general anti-avoidance rule.

Senior tax officers have unofficially informed KPMG Thailand, during informal discussions, that the TRD has drafted specific transfer pricing regulations and under which, like other countries, documentation is likely to be required by law. It is expected that these requirements will be most likely consistent with point 13 (Re-examine transfer pricing documentation) of the OECD's action plan to counter base erosion and profit shifting (BEPS).

The issuance of new transfer pricing regulations and/or guidelines by other ASEAN countries, such as Indonesia, Malaysia, the Philippines and Vietnam, has been putting increasing pressure on the TRD to develop and enhance its transfer pricing practices. Some practitioners expect that the specific transfer pricing regulations in Thailand should be enacted around 2014 or 2015.

The thin capitalisation, controlled foreign company and general anti-avoidance rules should be in line with the OECD's action plan to counter BEPS as well. However, no details have been disclosed yet.

Though Thailand is not an OECD member country, the TRD normally refers to the Organisation's guidelines for international standards and practice. For example, the TRD mostly accepts the transfer pricing methods and the comparability analysis approach specified under the OECD transfer pricing guidelines. However, the TRD does not apply the attribution of profits to permanent establishment (PE) in the guidelines. Based on the Thai Revenue Code, if there is a PE in Thailand, the income/gain derived by the PE is subject to corporate income tax in Thailand. The attribution of profits to PE based on the OECD transfer pricing guidelines would only be applied if the taxpayer has applied to the competent authorities for an APA or mutual agreement procedure (MAP).

Transfer pricing audit trends

Based on our experience in assisting multinational companies in dealing with the TRD on transfer pricing audits, we have noticed developments in its transfer pricing tax team and audit approach. The TRD has developed a specific transfer pricing audit team, which is part of the Large Taxation Office (LTO), which is responsible for large taxpayers and has been based at the Department's head office for more than 10 years. In the past, only the transfer pricing audit team would be responsible for transfer pricing issues, but now local tax officers across the country have been equipped with the basic transfer pricing knowledge and have been trained by the transfer pricing audit team. At present, it is common for local tax officers to raise transfer pricing issues during a general tax audit, which indicates that the TRD wants to focus more on transfer pricing audits. Any taxpayer without sufficient preparation or analysis of transfer pricing would be at risk. The key trends and enhancements of transfer pricing audits in Thailand are:

- Audit approach: The common practice in the past was that the TRD would issue an invitation letter to the taxpayer who was a target for a transfer pricing audit to meet at the tax office and to submit the information and documentation related to the transfer pricing as prescribed in DI Paw 113/2545. Starting in late 2011, the TRD began issuing a transfer pricing questionnaire or form to targeted taxpayers to gather information about:
  - The types of related-party transactions,
  - The transaction values,
  - The related suppliers' and customers' names,
  - Products purchased/sold,
  - Services provided/received and
  - Currencies used.

The submission of a completed questionnaire may or may not be followed by the issuance of the invitation letter. However in most cases, the invitation letter would be issued after taxpayers sent in the completed questionnaires.

- New target for audit: In the past companies under a tax exemption or tax holiday period would not be a target for a transfer pricing audit. However, the ball game has been changed. Even if the company is under a tax exemption period, the Thai tax officers will start conducting a transfer pricing audit on it if it is loss making. In Thailand the loss from a tax exempted business can be carried forward for five years after the expiry date of the tax exemption period. As a result, tax officers will investigate and challenge if the loss is appropriate and is eligible to offset the taxable profits after the expiry of the tax exemption period. The key resolution strategy to support this is to prepare

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transfer pricing documentation with justifiable business reasons for the loss. If the documentation can demonstrate clearly that the loss is incurred by factors other than transfer pricing, it should help to support the case.

- Focused transactions: One of the interesting trends is the increase in investigations of inter-company service transactions. The TRD believes that intercompany service fees is one of the common ways used by multinational companies to transfer profits out of Thailand. This is also one of the focus areas of the general tax audit team. The key challenge would be whether those services are beneficial to taxpayers' businesses in Thailand. If the taxpayer cannot prove the benefits received, the entire service fees will be treated as non-deductible expenses, resulting in additional tax payable or reduction of losses carried forward. In this regard, it is critical that the taxpayer is able to substantiate that the services are in fact beneficial to the business in Thailand. Taxpayers are also required to prove that any service fee is determined in accordance with the arm's-length principle.
- Co-operation within the TRD: It should also be noted that there is cooperation within the TRD. During its general audit, the general tax audit team may identify a target for a transfer pricing audit and/or may transfer the case to the transfer pricing audit team if the case is more complex and needs to be audited by a specialist. In this regard, any companies with inter-company transactions can be at risk because a general audit is normally conducted every one to three years.
- Transfer pricing adjustments will result in additional tax payable together with a surcharge of 1.5% a month of additional tax payable up to the amount of tax due and possible penalties of up to 100% of additional tax payable.

Trends triggering transfer pricing risks in Thailand

Transfer pricing adjustment

Many multinational enterprises try to manage the bottom line of their Thai subsidiaries. In doing this, they target the profit margin and if the Thai subsidiaries' profit margin is higher than the targeted margin, they will issue a credit note or issue an invoice for a fee to get the money back and hence reduce profits in Thailand.

A reduction in profit margin will draw attention from Thai tax officers. The targeted margin should be based on a Thai comparable search rather than a regional one. The adjustment may trigger other tax implications, such as withholding tax, value added tax and customs, depending on the underlying transactions that the adjustment is made for.

Fluctuation of foreign exchange rate

Since 2012, the Thai baht foreign exchange rate has fluctuated dramatically. This may affect a company's profitability, even causing the company to bear a loss. Though companies may realise some gain from foreign exchange, the transfer pricing audit team may not allow taxpayers to include such gains in the calculation of operating profits to increase their profitability. This is because the TRD believes that the gain/loss from foreign exchange is not an operating item. The key resolution strategies to tackle this would be to prepare the business reasons, actions to be taken to manage the loss, transfer pricing and functional and risk analysis, and supporting documents in advance.

Resolution strategies in thailand

Documentation is the top action that Thai taxpayers should prepare in advance because it is the first document the TRD will request from a taxpayer for its review and investigation during a transfer pricing audit. And, based on our transfer pricing audit and APA experience with it, the TRD reviews and considers only Thai comparable searches. If a taxpayer uses a regional comparable search for documentation, it is likely that tax officers will try to use their own Thai comparable set to challenge the taxpayer. As a result, a local comparable search is a must in transfer pricing analysis in Thailand.

Eight years after the issuance of DI Paw 113/2545, the TRD issued the Guidance on Advance Pricing Agreement (APA guidance) document in 2010. This APA guidance states that the TRD accepts only bilateral APAs. Since this guidance was issued, more and more taxpayers have applied for bilateral APAs. To speed up the APA process and consideration, the TRD requires that the APA submission should be in both Thai and English.

In Thailand the transfer pricing audit team at the TRD's head office is the APA working team. Representatives from each tax division of the Department (that is, the transfer pricing audit team, tax policy and planning team, legal team and others), with the director of the TRD as the president, make up the APA committee.

After the TRD issued the APA guidance, several taxpayers made requests for corresponding adjustments through MAP. If a taxpayer in Thailand would like to get a tax refund from the Department through a MAP, care must be taken. Under Thai tax laws, taxpayers can request a corporate income tax refund within three years from the filing date. If they fail to request the tax refund within this time limit, it is likely that the TRD will decline the application for MAP.

There are between 20 and 30 APA and MAP applications with the TRD from taxpayers in Japan, the US, Germany, Singapore and Korea.

Taxpayers in Thailand should take an active approach to managing the risks in advance by evaluating their own transfer pricing risks as well as preparing transfer pricing documentation. The earlier we prepare ourselves, the better we can manage risks and reduce exposures.

Getting up to speed in Vietnam

Hoang Thuy Duong, Tran Dong Binh, Ha Tran and Hoang Cao Doan Trang of KPMG in Vietnam explain how Vietnam has adopted a comprehensive transfer pricing regime.

Like other tax authorities in the region, the Vietnamese tax authority is trying to protect a fair share of tax from multinational companies operating in Vietnam with authoritative transfer pricing audits and inaugural advance pricing agreement (APA) regime.

In line with the action plan on transfer pricing management for the 2012-2015 period announced by the Ministry of Finance (MOF) in 2012, transfer pricing audits have been initiated by provincial tax departments under the General Department of Taxation's (GDT) instruction across a number of provinces in late 2013. The audits were carried out in the context of reduced tax revenue collection because of weaker economic growth while few audits were really carried out since the application of the transfer pricing regulations in 2006.

With the introduction of official regulations on application of mutual agreement procedures (MAP) and APA in late 2013, the Vietnamese transfer pricing regime has now become comprehensive.

Important new regulations

Advance pricing agreements

The APA regulations were introduced under the Amended Tax Administration Law which took effect from July 1 2013. Circular 201/2013/TT-BTC dated December 20 2013 (Circular 201) of the MOF provides detailed guidance on the APA regime, including principles, duration, procedures, right and obligations of tax authorities and taxpayers and other guidance for implementation. Circular 201 took effect as of February 5 2014 and has been welcomed by both taxpayers and tax authority in view of certainty and predictability of transfer pricing taxation APAs can bring about, protection of tax base, and efficiency in tax administration, especially against the backdrop of increasing transfer pricing controversies in the audits.

An APA is defined under Circular 201 as "a binding written agreement valid for a period of time between the tax authority and taxpayers, or amongst the tax authority and taxpayers and tax authorities of the nation and territories with which Vietnam has signed the tax treaty with respect to the determination of basis for tax calculation, transfer pricing method, or prices based on the arm's length principle. APA is established for a tax year before the taxpayers submit their tax return for that tax year".

An APA can be in the form of a unilateral agreement (that is, between taxpayers and the Vietnamese tax authority), a bilateral or multilateral agreement (that is, amongst taxpayers, the Vietnamese tax authority and foreign tax authorities having a tax treaty with Vietnam). Vietnam has around 65 tax treaties with most of its trading partners and a tax treaty is under negotiation with the US. During APA negotiation process, depending on specific facts and circumstances, taxpayers and the tax authority may change a unilateral APA into bilateral or multilateral, or vice versa.

The APA negotiation and conclusion procedures which consist of five steps – pre-filing consultation, formal application, evaluation, discussion and negotiation, and conclusion and circulation – are basically developed with reference to the OECD's APA guidelines and international practices, including advanced APA regimes and those countries which have recently applied APAs. According to the regulations, it is expected to take nine months from a submission of an APA request to the circulation of a concluded APA.

Duration of an APA can be maximum five years which can be extended for no more than five years provided that (i) there are no material differences in the scope of related party transactions, the transacting related party(ies) and critical assumptions, and (ii) the arm's-length range used for benchmarking purposes remains stable during the extended period. Retroactive application of an APA before the date of lodging an APA application is not allowed under the regulations.

The tax authorities are obliged to keep confidential all information and data used during the process of handling APA requests. Accordingly, where an APA application is terminated, withdrawn or cancelled, information supplied by the taxpayers in the application dossier or annual/ad-hoc APA implementation report(s) will not be used by the tax authority as evidence for tax audit purposes.

A number of pilot APAs have been discussed with the GDT while the tax administrators are active in preparing resources with capacity and building databases (including the possibility of using external databases).

Mutual agreement procedures

Although available in most of the double tax treaties to which Vietnam is a signatory, MAP has not been very practical for the taxpayers because of the lack of guidance on implementation. With the introduction of Circular 205/2013/TT-BTC dated December 24 2013 (Circular 205) of the MOF which provides guidance on double tax treaties, MAP may now be applied by taxpayers as an alternative to settle transfer pricing disputes.

Effective as of February 6 2014, Circular 205 provides two (2) separate MAP situations for taxpayers being tax residents of the treaty counterparty country, and tax residents of Vietnam in the event taxpayers believe that their tax liabilities were not assessed by the Vietnamese tax authority (with respect to the former) or by foreign tax authority (with respect to the latter) in accordance with the provisions of the relevant double tax treaty. Specifically:

- A foreign tax resident may choose to (i) carry out domestic appellation in accordance with the Vietnamese regulations or (ii) appeal directly to the Vietnamese competent authority (being the MOF or any person duly authorized by the MOF, which is the GDT) or the competent authority of the contracting state of which he/she is a resident to apply MAP in accordance with the double tax treaty; or
- A Vietnamese tax resident may request the Vietnamese competent authority to apply MAP.

To be eligible for applying MAP, taxpayers are required to:

- Fulfill all obligations which have been informed in an official decision on tax collection before and during the appeal process, except for the circumstance where a government competent authority decides to suspend the implementation of such a decision on tax amounts or tax impositions; and
- Apply for MAP within three years from the date of first notification by the tax authority in relation to the tax treatment which the taxpayers consider not to be in accordance with the relevant double taxation agreement.

New form for statutory disclosures of related party transactions from 2014

Circular 156/2013/TT-BTC (Circular 156) dated November 6 2013 introduces Form 03-7/TNDN (Form 03-7) for annual disclosure of related party transactions (RPT) which is to be submitted together with the taxpayers' annual corporate income tax return. Form 03-7 is applicable to the tax year commencing January 1 2014 onwards, and replaces Form 01 for the transfer pricing disclosure applicable to the earlier tax years.

With an aim to mitigate potential transfer pricing disputes, the new form requires, among others, taxpayers' voluntary disclosures of transfer pricing adjustments as self-assessed by the taxpayers. This means some supporting transfer pricing analysis should be carried out contemporaneously to support such disclosures, including the contention where nil adjustments are made by taxpayer companies on the self-assessment basis under the local current regulations.

Given the above, contemporaneous transfer pricing documentation has become, again, essential as evidence to support taxpayers' transfer pricing disclosure and compliance with the transfer pricing regulations. Greater attention should be paid to and more work should be done by taxpayers to complete the disclosures under the new form.

Unwavering transfer pricing audits

Under the action plan and pressures of 2013 tax revenue collection, during the fourth quarter of 2013, the GDT issued official instructions to 17 provincial tax departments to carry out transfer pricing audits at 42 textile, garment and footwear companies. The target companies were selected based on transfer pricing risk assessment (mostly loss making). The audits were carried out based on standard information request, risk assessment, reporting and adjustment templates. Although all of these audits were aimed to be completed by December 10 2013, only some of them were completed as of

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Duong has advised multinationals on tax, customs and transfer pricing planning and compliance, supply chain tax planning, business restructuring and provided tax due diligence and structuring advice on corporate transactions in various sectors.

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Binh has extensive experience in providing tax advisory services during the tax audit to foreign-invested companies.

February 26 2014 because of controversies on a number of important matters between taxpayers and tax authority:

- Preference for the cost plus method with respect to contract manufacturing or toll manufacturing, which presents a challenge to loss-making businesses in this sector;
- Use of secret company data with very high profit levels for transfer pricing adjustment purposes;
- Disregard of economic, market and commercial factors in analysing profitability of taxpayers in respect of transfer pricing;
- Arbitrary adjustments without sufficient consideration of the taxpayers' transfer pricing documentation; and
- Audits without robust procedures and consideration of the audited taxpayer companies' transfer pricing policy and commercial circumstances, and the transfer pricing regulations in relation to documentation and benchmarking, which gives rise to the risk of prolonged appellation and litigation.

It is noted that despite the authoritative instructions on profit levels for the purposes of making transfer pricing adjustments, chances for taxpayers to explain their circumstances and effectively close the audits at the field remain open. A number of audit cases show that negotiations with local tax authorities based on an appropriate benchmarking study can help close the audits.

It is important to note that the transfer pricing regulations require taxpayers to maintain contemporaneous transfer pricing documentation, meaning the burden of proof is shifted onto the tax authority. The use of secret comparables or making adjustments without sufficient consideration of the taxpayers' documentation by the tax authority, partly because of the lack of robust transfer pricing audit procedures, creates serious challenges for taxpayers and their voluntary compliance.

The current audits may drive the need for transfer pricing certainty and elimination of double taxation via competent authority.

The future

Vietnamese tax authorities have taken several serious steps to build capacity (with support from OECD experts) and conducted the first real transfer pricing audits. Still, some important initiatives are needed towards a mature system of transfer pricing management.

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Ha's sector experience includes transfer pricing, taxation, trade & customs.

Given the Action Plan until 2015 where the number of transfer pricing audits may be in the region of 1,500 per annum, there are likely more transfer pricing audits in respect of certain sectors and companies with a perceived high transfer pricing risk, such as garment, footwear and potentially other sectors including steel, electronics, and diversified manufacturing. The challenges for the tax authorities to carry out a viable audit program are to improve audit procedures, audit capacity, and use external databases (rather than solely relying on secret comparables data).

The regulations are planned to be changed to enable effective transfer pricing management and compliance. Given the OECD discussion draft on transfer pricing and country-by-country reporting and a number of actions to counter base erosion and profit shifting (BEPS), it is likely that the Vietnamese policy makers will watch out for international developments before amending the local regulations.

For taxpayers, albeit new, MAP and APA can now be considered as workable options to resolve transfer pricing controversies, create certainty and mitigate double taxation.

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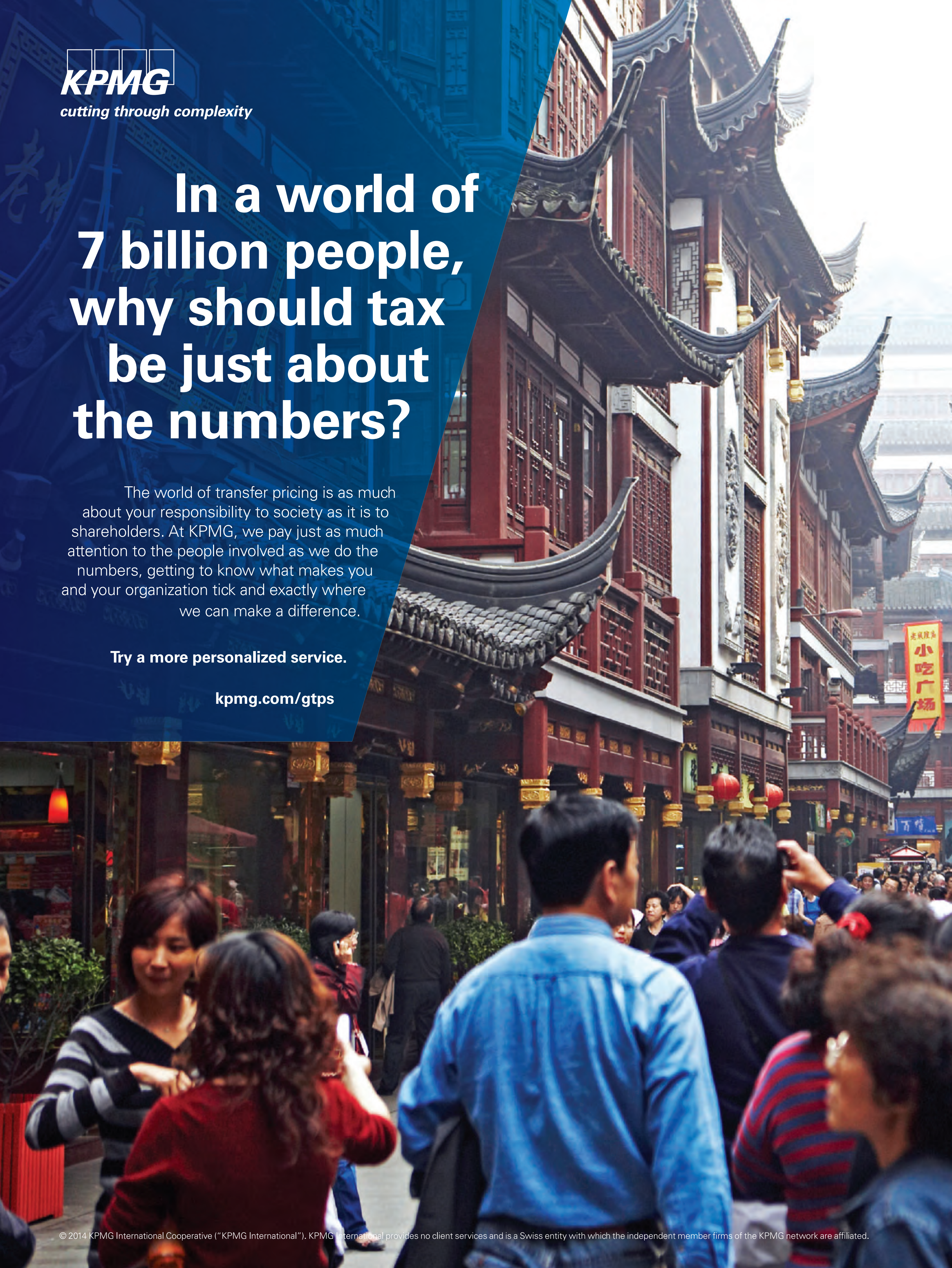
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