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GLOBAL TAX

A World in Transition

**Managing the
Transfer Pricing Implications
of Complex Supply
Chains**

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TAX

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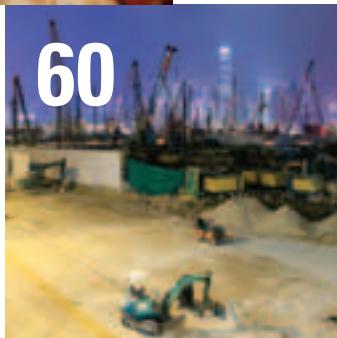
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Introduction



Transfer pricing issues involving corporate supply chains have become increasingly complex and controversial in recent years. Part of this increase is business-driven – there is growing international specialization. In the late 1990s, a typical supply chain might have included manufacturing, distribution and a centralized intangible holding company. But in 2011, that supply chain has grown to add procurement companies, a centralized financing function, contract research and development (R&D) centers, and services centers; split manufacturing functions among multiple legal entities; and moved from traditional distribution to internet sales. Managing the transfer pricing implications of such complex supply chains – a challenge under the best of circumstances – has been further complicated by the growing focus of tax authorities on transfer pricing in an effort to make sure that they are able to tax an appropriate share of corporate income.

This publication focuses on three discrete types of supply chain issues. Section I discusses the implications of the new Organisation for Economic Co-operation and Development (OECD) Guidelines on business restructuring and is divided into the following sections:

- an overview of new Chapter IX of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises*
- specific country perspectives on business restructuring concepts
- a short discussion of the new OECD project on intangibles.

In reading the various articles, it is worth focusing on several issues.

- The OECD Guidelines on business restructuring effectively treat a wide range of non-tax business decisions as transfer pricing issues. What steps does a corporate tax department have to take to (i) identify when a business restructuring will be treated as a transfer pricing event and (ii) prevent "foot faults" that may lead to large transfer pricing challenges?
- The OECD Guidelines explicitly did not address the relationship between business restructuring and local tax rules. However, these relationships are often important. On the positive side, certain issues that were viewed as local law and therefore not eligible for competent authority relief are now characterized as transfer pricing issues, and therefore presumably are covered by double tax protection. On the other hand, some business restructuring payments may trigger immediate revenue recognition in one jurisdiction

but may be treated as a capital cost that is deductible only over a number of years in the other jurisdiction.

- The OECD Guidelines are based on an economic model of business decision-making in which the decision-maker is located at a specific legal entity. This often does not reflect the business reality of many corporate entities, where the decision-making is "virtual" in that it reflects the input and decisions of a group that spans a number of legal entities.

Section 2 focuses on a few selected issues that arise in the supply chains of many multinational enterprise (MNE) supply chains. The topics we have selected to cover are ones that KPMG's Global Transfer Pricing practice has found to be of immediate interest to many MNEs.

- The views expressed by the Chinese tax authorities in a recent training session on automotive industry transfer pricing issues. While this article focuses on the automotive industry, many of the issues that are raised apply equally to other industries.
- New developments in the relationship between customs and transfer pricing regulations. This issue is especially important in Asia as many countries have high duty rates, leading to significant potential costs where companies are required to report different prices for transfer pricing and customs tax purposes.
- Issues associated with the use of procurement companies. The MNE supply chain typically includes third-party as well as related suppliers, and many companies have set up

specialized procurement companies to manage their dealings with such third-party suppliers. The question of whether such procurement companies should be paid based on the value that they bring to the organization or the costs that they incur (excluding the cost of the materials that they purchase) has been a frequent source of controversy between taxpayers and tax authorities.

- Location savings. Do the cost savings associated with using low-cost sources of supply lead to higher profits, and if so, which entity is entitled to such profits?

Section 3 discusses controversy – what options do taxpayers have in resolving inevitable conflicts with tax authorities? This part of the report starts with a look at the controversy landscape in India, a key country that houses the IT and back-office services of many MNE supply chains and that has what many taxpayers view as an extremely aggressive approach to transfer pricing. The section continues with a discussion of the rapid increase in the use of advance pricing agreements (APA) in Asia and the development of two new tools to help taxpayers resolve controversy – accelerated competent authority procedures (ACAP) and binding arbitration. The section closes with a discussion of two court cases that have significant implications for supply chain management and restructuring – the *GE Capital* case in Canada dealing with intercompany loan guarantees and the *Veritas Software* case in the US dealing with the issue of what has to be paid for when intangibles are migrated.

Stephen Blough, co-editor
Principal
KPMG in the United States –
Washington National Tax
Email: sblough@kpmg.com

Clark Chandler, co-editor
Principal
KPMG in the United States –
Washington National Tax
Email: cjchandler@kpmg.com

Francois Vincent, co-editor
Partner
KPMG in Canada
Email: fvincent@kpmg.ca

Section 1

Business Restructuring



Overview of the New OECD Guidelines

Business restructuring is not a new issue – a number of tax authorities (e.g. in Canada, the Netherlands, Denmark, France, and Germany) have not only sought payments for explicit transfers of intangibles, they have also sought to impose “exit charges” when domestic businesses either close down or downsize. Such charges can be implemented by requiring an explicit payment from the legal entity that initiated and/or benefited from the restructuring, or, as in Spain and Belgium, by simply disallowing deductions for closure costs under domestic tax law.

On July 22, 2010, the Organisation for Economic Co-operation and Development (OECD) broadened the scope of its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*¹ (OECD Guidelines) and formally incorporated business restructuring issues with the release of “Chapter IX: Report on the Transfer Pricing Aspects of Business Restructuring.” This new chapter broadly defines business restructuring to include: “... the cross-border re-deployment by a multinational enterprise of functions, assets and/or risks.” In essence, a business restructuring can involve almost any substantive change in a business relationship, including:

- a change in the nature or scope of transactions among controlled entities
- a shift in the allocation of risks
- a change in responsibility for specific functions
- termination of the relationship.

The formal extension of transfer pricing to this broadly defined concept of business restructuring has important implications. For example, multinational enterprises (MNE) may be expected to document a much broader range of changes in their business operations than they were in the past under local documentation

requirements. In countries such as Spain that have traditionally dealt with closure costs as a domestic issue, the application of Chapter IX of the OECD Guidelines may push the closure costs into the international arena and result in enhanced ability to access competent authority.

Importantly, the OECD Guidelines state that the arm’s-length principle does not and should not apply differently in the case of restructuring than in other transfer pricing contexts. Moreover, the OECD Guidelines state that there is not always a need for a payment because of a business restructuring or because of the termination of a business relationship; a payment is only needed if it would be made between uncontrolled entities. The OECD Guidelines state that payments are not needed for the mere transfer of profit potential. Payments are required if compensation would be expected among parties operating at arm’s length. This position contrasts with the approach to valuing transfer packages that has been adopted in Germany and with the business valuation approaches used by the United States under its cost sharing rules to capture the value of goodwill and going concern into its exit payments.

Under Chapter IX, MNEs contemplating a change in business structure or intercompany relationships now have to think about the arm’s-length standard in terms of:

- their initial structure
- their new structure
- the payments (if any) that would be expected at arm’s length on converting from one structure to the other
- the implications (if any) of the prior structure and the nature of the restructuring for prices under the new structure.

Importantly, the OECD Guidelines state that the arm’s-length principle does not and should not apply differently in the case of restructuring than in other transfer pricing contexts.

¹ The existing OECD Guidelines were supplemented by the report on the transfer pricing aspects of business restructurings, adopted by the Committee on Fiscal Affairs on June 22, 2010 [CTPA/CFA(2010)46] and approved by the OECD Council on July 22, 2010 [Annex I to C(2010)99], incorporated in Chapter IX.

The OECD Guidelines emphasize the importance of clearly defining the structure of the transaction in terms of functions, assets and risks both before and after restructuring.

The OECD Guidelines further state that tax authorities should respect the form established by the taxpayer in all but extraordinary circumstances, which are characterized as “rare” or “unusual.” Such exceptional cases are defined as situations in which:

- the substance of a transaction differs from its form
- the transaction is one to which third parties would not have agreed and for which an arm’s-length price cannot be reliably determined.

This treatment may help taxpayers in countries such as Canada, where tax authorities have taken the position that they can overturn a taxpayer’s business structure in some circumstances. However, the OECD Guidelines emphasize the importance of clearly defining the structure of the transaction in terms of functions, assets and risks both before and after restructuring. Written agreements are recommended. Wherever possible, tax authorities are directed to respect the structure set up by the taxpayer and to require pricing that reflects the structure.

New Chapter IX devotes an entire section to the discussion of risk. The OECD Guidelines make it clear that tax authorities should respect the contractual allocation of risk established by the MNE but note that tax authorities can legitimately examine:

- whether the conduct of the parties is consistent with the contractual allocation of risk
- whether the allocation of risk in the controlled transactions is arm’s length.

The second of these factors is perhaps the most important. The OECD Guidelines state that taxpayers can show that an allocation of risk is arm’s length either by showing that there are third-party arrangements with the same allocation

of risk or by demonstrating that, while not seen in a third-party arrangement per se, the allocation of risk is in fact one that could be expected among unrelated parties. In the latter case, the OECD Guidelines stress the importance of showing:

- control over risk, which does not require the management of day-to-day decisions but does require the presence of employees or directors who have the authority to perform control functions
- financial capacity to assume the risk, which suggests that the risk-bearer should generally have the financial capacity to assume the risk at the time of the contractual allocation or transfer of risk to it, or the capacity to protect itself should the risk materialize.

Under the OECD Guidelines, the risk-bearer would be expected to make decisions on assuming the risk (i.e. put capital at risk) and on whether and how to manage the risk (i.e. internally or using an external provider). Thus the risk-bearer would be required to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. The OECD Guidelines acknowledge that control does not require the day-to-day management of the risk. However, where management of the risk is outsourced, the risk-bearer would generally be expected to make relevant decisions to control its risk, for example, by:

- taking responsibility for the decision to hire or terminate the entity that is managing risk on a daily basis on the risk-bearer’s behalf
- determining the type of work that is being done
- making key spending decisions
- assessing the outcome of the work done.

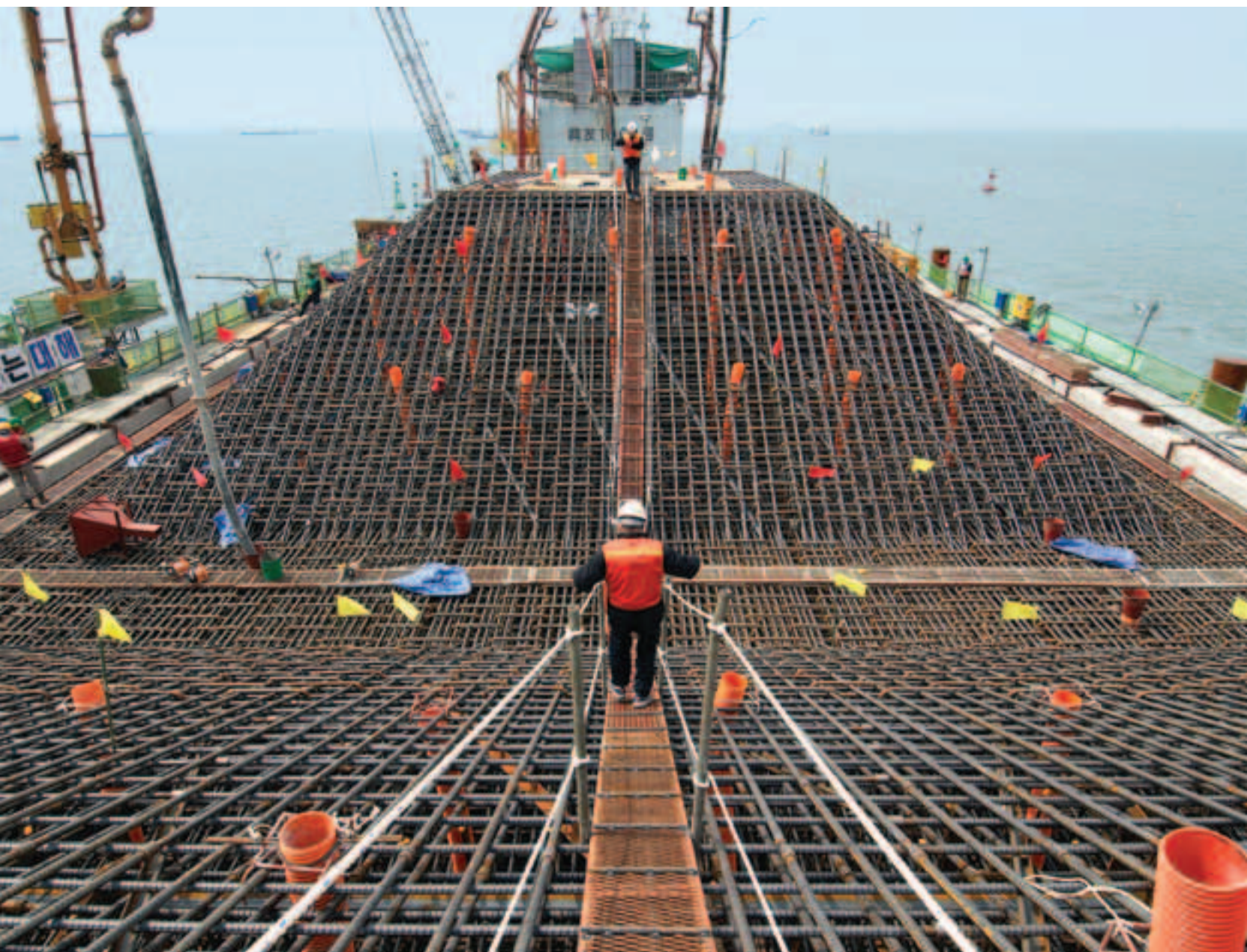
In discussing financial capacity to assume risk, the OECD Guidelines suggest that the risk-bearer should generally have sufficient financial resources to assume the risk at the time of the contractual allocation or transfer of risk to the risk-bearer. The OECD Guidelines also note that the financial capacity to assume the risk is not necessarily the financial capacity to bear the full consequences of the risk materializing. Further, a high level of capitalization does not by itself mean that the highly capitalized party is capable of carrying the risk.

The new OECD Guidelines on business restructuring emphasize the need to consider the options that are realistically

available to the two parties, including the option not to restructure. This evaluation is intended to be somewhat pragmatic – exploring every possible option is not necessary – but it does imply giving more attention to the business reasons for the restructuring and its economic consequences. Importantly, the examination of options:

- takes into account the options of both the controlled seller and the controlled buyer
- analyzes the perspective of the controlled affiliate as a stand-alone entity rather than the perspective of the corporate group.

The new OECD Guidelines on business restructuring emphasize the need to consider the options that are realistically available to the two parties, including the option not to restructure.



In evaluating the implications of the new guidance on business restructuring, the core question is how local tax authorities will interpret it.

One potentially troubling aspect of the OECD Guidelines is the statement that payments may sometimes be needed for the transfer of a going concern and thus are not limited to transfers of tangible and intangible property per se. The OECD Guidelines suggest that “valuation methods that are used in acquisition deals between independent parties may prove useful to valuing the transfer of an ongoing concern between associated enterprises.” A key question is whether this statement implies the use of enterprise-based pricing approaches (such as those set forth in the IRS’ Coordinated Issue Paper on Buy-in Transactions and in the US Temporary and Proposed Cost Sharing Regulations), which would further imply that value should be determined over an infinite life.

In evaluating the implications of the new guidance on business restructuring, the core question is how local tax authorities will interpret it. As discussed in more detail in the sections on individual countries below, the answer to this question varies by tax authority. This issue is not new: a number of tax authorities have already focused on business restructuring issues. For example, Canada’s tax authorities have asserted that a charge could be levied on an MNE where the functions or risks of a Canadian affiliate were changed or reduced due to a decision from a non-resident head office that led to reduced income in Canada. In many cases, such as in Denmark and the Netherlands, tax authorities are likely to use the concepts set forth in the new OECD Guidelines to support their current review of such business restructuring issues.

Spain and Belgium have traditionally dealt with restructuring issues by disallowing deductions under local tax law. The new OECD Guidelines on business restructuring will move these tax issues from the domestic to the international level.

In other cases, local tax authorities are likely to adjust their approaches to exit charge issues to reflect the concepts set forth in Chapter IX. France is likely to cite specific parts of the new OECD Guidelines to reinforce its position

that local commercial law must be taken into account in determining the indemnification payable to a French legal entity because of a reduction in profits following a business restructuring. On the other hand, Spain and Belgium have traditionally dealt with restructuring issues by disallowing deductions under local tax law. The new OECD Guidelines on business restructuring will move these tax issues from the domestic to the international level. Particularly in the case of Spain, the new OECD Guidelines may provide taxpayers with more effective arguments in dealing with the Spanish tax authorities while also providing better access to competent authority and therefore a greater potential for double tax relief.

The United States does not follow OECD rules, and US transfer pricing rules do not discuss restructuring issues explicitly. However, the IRS is pushing to expand the definition of what payments are required following an outbound migration of intangibles.

Germany is an interesting case in point. The country has adopted a completely different approach to business restructuring issues that largely ignores the role of risk allocation and contractual terms in favor of a standardized computation based on the value or the profit potential of the aggregate “transfer package” to the transferor and the transferee. It remains to be seen whether this unique approach will be moderated, either locally or in competent authority negotiations, in light of the new OECD Guidelines.

China, which is not an OECD member, is concerned that OECD rules may be biased in favor of the more developed Western economies. Chinese tax authorities are also likely to discount the contributions of foreign intangibles and focus on the contributions of local economic attributes. Japan’s treatment of intangible ownership differs from the traditional OECD view by focusing on the entity that carries out the underlying research and development (R&D) rather than on the entity that funds the R&D and bears the related financial risks. Undoubtedly other countries will also continue to follow their own unique approaches to business restructuring issues.

Reactions from Local Tax Authorities



Australia

Relying on OECD's Business Restructuring Guidance

Australia does not have specific rules dealing with cross-border business restructuring. Rather, the income tax consequences that flow from business restructurings are determined by reference to general income tax law provisions together with Australia's transfer pricing rules. In February 2011, the Australian Tax Office (ATO) issued Taxation Ruling TR 2011/1 (*Income tax; application of the transfer pricing provisions to business restructuring by multinational enterprises*) ("TR 2011/1") on the application of Australia's transfer pricing rules to cross-border business restructurings. TR 2011/1 does not address the application of other Australian income tax laws that are often relevant to business restructurings such as the capital gains tax (CGT) rules,² the capital allowance rules,³ and the controlled foreign company provisions. In particular, TR 2011/1 provides no guidance on the circumstances in which the ATO considers that goodwill (which is a CGT asset under Australia's CGT rules) has been transferred to a related party in connection with a business restructuring.

Broadly speaking, TR 2011/1 is consistent with the Organisation for Economic Co-operation and Development (OECD) position on business restructurings. In particular, TR 2011/1 states that the ATO will generally follow the OECD Guidelines on business restructuring. In adopting this position, the ATO appears to acknowledge

the right of a business to change the structure of its international related-party dealings, so long as the restructuring is completed in a way that makes commercial sense for all parties involved.

A fundamental issue for the ATO is to understand the business reasons for and the benefits expected from the restructuring. The factual support for the position can be equally important to the economic analysis.

The arm's-length principle remains the key tenet from a transfer pricing perspective. Certainly there is the expectation under TR 2011/1 that the transfer of valuable assets and the future functionality of the parties will be compensated in a manner consistent with the way that independent parties in comparable circumstances would expect to be compensated. However, a fundamental issue for the ATO is to understand the business reasons for and the benefits expected from the restructuring.⁴ The factual support for the position can be equally important to the economic analysis.

In evaluating a business restructuring the ATO may consider key factors that an independent business would likely consider before accepting the terms of the business restructuring. Such factors might include whether the local entity has acted in its own economic interest, whether the terms make business sense for the local

² Contained in Part 3-1 of the *Income Tax Assessment Act 1997*.

³ Contained in Part 2-10 of the *Income Tax Assessment Act 1997*. The capital allowance rules apply where "depreciating assets" are disposed of under a business restructuring. Depreciating assets include plant and interests in relation to copyright, patents and registered designs.

⁴ While generally consistent with Section B of Part II of Chapter IX of the OECD Guidelines, TR 2010/D2 provides greater detail on matters the ATO will consider in determining whether the pricing of a business restructuring arrangement is arm's length.

entity, and whether all realistically available options were considered, including the option not to restructure. In undertaking such an evaluation, TR 2011/1 indicates that the ATO will generally consider:

- the expected benefits of the business restructuring for the parties
- the other options realistically available to the parties at arm's length
- the allocation of risk under the restructured arrangements
- whether an amount of consideration might be expected under an agreement between independent parties in comparable circumstances.

To build a solid foundation to support a business restructuring before the ATO, MNEs are well advised to retain:

- detailed strategy documents from the business that demonstrate the company's decision-making process regarding its business restructuring, including, if available, input from the Australian entity

- internal memoranda or other documentation evidencing that alternative operational structures were considered and that such alternatives are business-driven
- a detailed before-and-after functional analysis of the relevant business operations, including identification of potential relocation of assets (including intangible property) and potential redistribution of risks among international related parties, in order to help clarify the changes to the business from a transfer pricing perspective
- financial analyses prepared contemporaneously with the business restructuring demonstrating the potential effects on the Australian business, ideally including a comparison of past and expected future performance and discussion of how the business restructuring specifically contributes to the forecast results.

While business restructurings can be quite complicated, in Australia the process can generally be successfully managed by paying careful attention to the preparation of appropriate contemporaneous documentation that addresses the business reasons underlying the need for the business restructuring.

Contributors:

Tony Gorgas
KPMG in Australia
Email: tgorgas@kpmg.com.au

Damian Preshaw
KPMG in Australia
Email: dpreshaw@kpmg.com.au

Anthony Seve
KPMG in Australia
Email: aseve@kpmg.com.au



Belgium

Documenting Business Restructuring Rationale Pays Off

Belgian law does not require the preparation of transfer pricing documentation, and no special contemporaneous documentation or reporting requirements are in place for extraordinary transactions and business restructurings. However, proactively documenting the rationale of a business restructuring is important to mitigate any resulting tax exposure. As in Spain, where the Belgian group entity bears significant costs resulting from a business restructuring, the chief challenge would likely stem from general tax rules rather than the transfer pricing requirements: one of the conditions of Article 49 of the Belgian *Income Tax Code* is that the expenses should be borne in order to retain or obtain taxable income. Therefore, it is especially important to investigate whether these restructuring expenses meet these requirements. Experience shows that it pays to be proactive in reflecting on this question and documenting the analysis.

As in France, Belgian tax authorities often look to local commercial rules when evaluating whether business restructuring payments are needed. For example, when assessing business restructurings involving distribution functions, one should take into account the provisions of the Belgian Law of July 27, 1961, modified in 1971, regulating the unilateral termination of exclusive distributorship agreements of an undetermined period. According to these provisions, a supplier unilaterally terminating the agreement should either respect a reasonable notice period

or pay the distributor an indemnity to compensate for the insufficiency or lack of notice. Belgian case law order should be consulted for guidance on what is deemed to be a reasonable notice period and/or appropriate compensation.

Finally, the Belgian tax authorities generally follow the Organisation for Economic Co-operation and Development's (OECD) work and can be expected to pay close attention to the new OECD project examining the transfer pricing aspects of intangibles. To the extent this project suggests expanding the definition of intangibles, the views of the Belgian tax authorities may be affected. For example, in Belgium, the mere transfer of people or workforce in place should not, in principle, give rise to a compensating payment or an exit charge under the current tax rules or tax practice. Indeed, apart from considering a workforce in place as one of the so-called soft intangibles, a company/taxpayer can hardly claim or take ownership of its workforce or report it as an asset on its balance sheet. On the contrary, the knowledge and expertise of the workforce in place is an intangible asset that is proper to the employees concerned. However, workforce in place will be clearly among the topics discussed in the course of the OECD project. The Belgian tax authorities will closely monitor these discussions and their outcome, and the current tax rules and/or tax practice may change accordingly.

Belgian tax authorities often look to local commercial rules when evaluating whether business restructuring payments are needed.

Contributor:

Dirk Van Stappen
KPMG in Belgium
Email: dvanstappen@kpmg.com



Canada

Focus on Business Restructuring Persists

The Canada Revenue Agency (CRA) began considering business restructuring issues in audits as early as the mid-1990s and started taking public positions on these issues as far back as 2003. Tax authorities in Canada have asserted that a charge could be levied on an MNE where the functions or risks of a Canadian affiliate were changed or reduced as a result of a decision emanating from a non-resident head office that led to a reduction in income in Canada. In fact, the CRA has defined the changes that could lead to such an exit charge very broadly – a change in the mix of products manufactured in Canada, the transformation from a full-fledged manufacturer to a toll manufacturer, or the transformation from a distributor to a commission-based sales organization can all trigger the application of a form of exit charge in Canada.

The Canadian tax authorities have also felt it necessary to include a power to recharacterize transactions in Canada's transfer pricing legislation. The CRA can exercise this power where two criteria are met:

- the transaction would not have been entered into between persons dealing at arm's length
- the transaction can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

This power is separate from the general transfer pricing legislative mechanism found at paragraphs 247(2)(a) and (c) of Canada's *Income Tax Act*,⁵ which essentially paraphrase paragraph 1 of Article 9 of the OECD Model Tax Convention.

The Canadian tax authorities have also felt it necessary to include a power to recharacterize transactions in Canada's transfer pricing legislation.

Contributors:

Mary Furlin
KPMG in Canada
Email: mfurlin@kpmg.ca

Michael Glaser
KPMG in Canada
Email: mglaser@kpmg.ca

⁵ Income Tax Act (1985, c. 1 (5th Supp.)).



China

Skepticism Over Foreign Intangible Values

While the State Administration of Taxation (SAT) does not have explicit rules on restructuring, it has recently issued substantial transfer pricing guidance that has important implications for taxpayers that are undergoing such business restructuring. A key difference between the SAT approach and the Organisation for Economic Co-operation and Development (OECD) Guidelines is in the treatment of contracts and the contractual allocation of risk. While the OECD Guidelines generally state that tax authorities should respect the allocation of risk as established by the taxpayer, subject to certain constraints, the SAT tends to make direct inferences about risk from functions performed without paying much deference to contractual terms. Thus, a single-function entity is assumed to be a low-risk entity that should not incur losses; a complex, multi-function entity should not be treated as low-risk regardless of specific contractual provisions limiting risk.

The SAT generally deals with intangible valuation and exit charge issues from the perspective of the payor. A number of OECD countries focus more on intangible valuations and exit charge issues from the perspective of the payee. As a result, the Chinese tax authorities are generally skeptical about the value of external

contributions and often focus on the value of local contributions. Thus, Chinese tax authorities are inclined to discount the value of legal rights to a trademark and to focus more on the value that they believe is associated with local functional contributions through advertising and other forms of marketing. Similarly, the SAT tends to focus on location savings as a potential source of cost savings that would support higher profits at the local Chinese affiliate.

The nature and direction of the views of Chinese tax authorities on some of the issues that are raised in the new OECD Guidelines were clearly set forth in the recent training of key SAT officials in July 2010. While this training focused primarily on the automotive industry, the basic economic and transfer pricing issues discussed at the training extend to other industries and are important to understand from a supply chain perspective. (See “Insights from SAT Training on Automotive Issues.”)

The Chinese tax authorities are generally skeptical about the value of external contributions and often focus on the value of local contributions.

Contributors:

Lu Chen
KPMG in China
Email: lu.chen@kpmg.com

Cheng Chi
KPMG in China
Email: cheng.chi@kpmg.com



Denmark

Tax Authorities Focus on Business Restructuring

Over the last couple of years, the Danish tax authorities have focused on transfer pricing matters with respect to restructurings. They have searched for companies that have undergone a restructuring by reviewing various newspapers and magazines, and, in several cases, claimed that a transfer of intangible assets has taken place at values derived from the discounted value of the lost profit potential. Many of these cases have been discussed in the news media, leading to negative publicity for the companies involved, initially because of concern over lost workplaces and later because of concerns over lost tax revenue.

Since the draft of the new Organisation for Economic Co-operation and Development (OECD) Guidelines was released, Danish tax authorities have been referring to them during transfer pricing audits – especially the sections that favor the tax authorities. The tax authorities' use of the reasoning set forth in the OECD Guidelines on business restructuring has even been applied retroactively to audits covering periods before the draft OECD Guidelines were released. In some of these cases, the tax authorities have looked into "other options realistically available" for the restructured entity. Tax authorities have accepted the new OECD Guidelines largely in order to use the specific concepts that support higher exit charges.

The Danish tax authorities are increasingly arguing that the difference in income before and after a restructuring is a value attributable to some sort of intangible asset (the right to not yet defined intangible assets calculated as the discounted cash flow of future expected earnings). The outcome of a transfer pricing audit therefore greatly depends on the documentation of the key factors that support the proposition that no payments are needed, and so the documentation should set out the rationale of the business case for the restructuring. There is not sufficient legal practice in the area to derive any case law trends, but similar to France the outcome of ongoing transfer pricing litigation will most likely influence Denmark's treatment of exit charges in the future.

Taxpayers engaged in business restructurings should therefore carefully document the business reasons for the restructuring and the arm's-length nature of any exit charges using the concepts set forth in the OECD Guidelines to better their chances of withstanding tax authority challenges and to avoid a shift in the burden of proof. Such documentation should focus on the timing of implementation, the arm's-length nature of and the taxpayer's adherence to contractual agreements (e.g. termination notices), and the options available to each party.

The Danish tax authorities are increasingly arguing that the difference in income before and after a restructuring is a value attributable to some sort of intangible asset.

Contributor:

Henrik Lund
KPMG in Denmark
Email: hlund@kpmg.dk



France

Emphasizing Local Commercial Law

France has historically used two unique concepts to address issues concerning business restructuring.

- *Fonds de Commerce*. This concept is clearly defined in law, but difficult to translate in one single concept in English. A good way to explain its meaning is to see it as a measure of the various elements used by merchants to acquire and keep their clientele. These elements are considered as a whole and valued as such for purposes such as successions and balance sheets, forming the object of legal transactions according to special rules (e.g. for transfer, hire, pledge, succession upon death) and protected as such in their own right. The *fonds de commerce* concept clearly captures the goodwill and going concern associated with the expected continuation of a historic business relationship.
- Prevention of an “abnormal act of management.” This concept refers to decisions of management that fail to adhere to its fiduciary obligation to act in the best interest of the stand-alone French entity, rather than as a member of the consolidated group. This concept is not restricted to taxation; the idea arises from well-established local commercial case law.

Neither concept is new. The French tax authorities are litigating a case based on *fonds de commerce*. However, in light of the new Organisation for Economic Co-operation and Development (OECD) Guidelines, the French tax authorities are likely to evolve away from these approaches toward ones more in line with those of the OECD. In this regard, the French tax authorities can be expected

to argue more often that an “indemnity payment” is needed to indemnify a French entity that has suffered an economic loss as a result of a business restructuring.

To determine whether an indemnification payment is warranted, the French tax authorities start by considering the factors set forth in the OECD Guidelines, which include the following.

- *Contractual terms*. Does the contract give the French legal entity explicit protections?
- *Functional analysis*. Has a real change in the roles and responsibilities occurred? In looking at this issue, the tax authorities will request functional diagrams and a DAS1 Form. The form is related to French labor laws and requires the company to list the details of its employees. The French tax authorities will examine the DAS1 Form before and after the business restructuring; the absence of payroll changes may be considered as indicating that no functions have moved.
- *Risk*. The French tax authorities will consider whether there has been a substantive shift in risk by examining the historical realization of risks transferred and, if the transferred risks have a history of low realization, the tax authorities will question whether a third party would accept reduced remuneration for a risk that has not materialized to date.

As a final step, French tax authorities will determine whether the French taxpayer would have recourse under established French commercial law beyond that provided in the intercompany contracts. Substantial legal precedent allows French companies to appeal for

In light of the new OECD Guidelines, the French tax authorities are likely to evolve away from these approaches toward ones more in line with those of the OECD.

commercial protections over and above those contained in formal contracts. For example, a French distributor successfully sued its unrelated supplier for canceling its distribution agreement. Even though the supplier complied with the 12-month cancellation notice called for in the distribution agreement, an Appeals judge ruled that the French distributor suffered losses and indemnified the party for an additional six months due to the following factors.

- The contract accounted for 40 percent of the injured party's business and thus the injured party was economically dependent on the contract.
- The distribution relationship had been in place for 35 years.
- The product was profitable for the distributor and the cancellation of the distribution agreement led to a substantial reduction in profits and caused economic harm.

The judge said that no single factor was determinative on its own. In combination, however, these factors suggested that the 12-month notice was not adequate and that six more months should be added.

French tax authorities are likely to view the new OECD Guidelines on business restructuring as generally supportive of their positions. In particular, Paragraph 9.106 states that "... because the same divergence of interests that

exists between independent parties may not exist in the case of associated enterprises, the question can arise whether the terms of a contract between associated enterprises are arm's length." In addition to relying on this paragraph to go beyond the actually stated contractual terms and conditions, the French tax authorities are also likely to cite Paragraph 9.115, which states in part that "The applicable commercial legislation or case law may provide useful information on indemnification rights..." This statement also supports the proposition that local legal remedies may mandate a payment even when no such payment would be required under specific contractual terms.

The outcome of ongoing transfer pricing litigation may influence France's treatment of exit charges in the future. In one case, the French tax authorities relied on the *fonds de commerce* concept to argue that, when an MNE converted its French affiliate from a full-fledged to a limited-risk entity, a substantive shift in business occurred that required a payment even though client billings did not change (the limited-risk entity still invoiced its old clients). Reaching a settlement has been difficult in this case because the French tax authorities view the issue as a matter of principle. In ruling against the taxpayer, the lower court held that there was a transfer of *fonds de commerce*. The taxpayer is appealing the decision.

The outcome of ongoing transfer pricing litigation may influence France's treatment of exit charges in the future.

Contributor:

Jan Martens

Fidal International

Email: jmartens@fidalinternational.com

*Fidal is an independent legal entity that is separate from KPMG International and KPMG member firms.



Germany

Considering the Value of the Hypothetical Transfer Package

Germany's approach to business restructuring issues is founded on different intellectual concepts than the Organisation for Economic Co-operation and Development (OECD) Guidelines. The OECD Guidelines start by considering specific legal entity risks and transactions. The amendments in Germany's *Foreign Transactions Tax Act* (AStG),⁶ in effect since January 1, 2008, contain a provision on so-called base shifting (transfer of functions, including business opportunities, risks and assets). This provision generally requires that compensation for the transfer be calculated for the whole transfer package rather than its discrete parts. The calculation is based on a specific formula that considers the impact of the function shifted on the expected profits of the transferring and receiving companies, generally without reference to intercompany contractual terms, risk allocation, etc.

Under the German rules, a transfer of function occurs where an enterprise (the transferring enterprise) conveys assets and other benefits to a related enterprise (the receiving enterprise), together with the associated opportunities and risks, or provides these so that the receiving enterprise can exercise a function previously exercised by the transferring enterprise, thereby restricting the transferring enterprise's ability to do so. A transfer of a function involves the transfer of a so-called transfer package that consists of the functions, their associated opportunities, and the assets and benefits that the transferring enterprise conveys to the receiving enterprise.

Under the decree, where arm's-length comparables are not available (as is usually the case), the price of the transfer package shall be determined by means of a hypothetical arm's-length comparison. The total value of the transfer package is then determined according to the profit potential of the function being transferred. Profit potential is the net after-tax profits

(present value) that, at the time of transfer, the transferred function may be expected to generate based on both:

- the amount a reasonable and conscientious business manager acting for the transferring enterprise would be willing to receive in consideration
- the amount that a business manager acting for the receiving enterprise would be willing to pay in consideration.

The minimum price of the transferring enterprise determined on this basis and the maximum price that the receiving enterprise would be willing to pay form the so-called range of agreement. The price in the range of agreement that reflects the arm's-length principle with the highest degree of probability is the price that is actually applied. However, unless a credible showing can be made in favor of another value, this price is assumed to be the midpoint in the range of agreement. Unlike the OECD Guidelines, the German rules assume that such a payment would be made without further examining whether the related parties, acting at arm's length, would have a legal right to terminate an agreement or shift a function without creating payment obligations.

The differences between the underlying rationales of the German regulations and the OECD Guidelines often make it difficult to reconcile the results of applying the two approaches, which will likely complicate the process of obtaining effective double tax relief. Three examples of such issues are described below.

Example 1: The OECD Guidelines on business restructuring state that there are some cases in which no payment would be expected for a business restructuring, even if it results in a reduction in the profits of the restructured entity. How does this compare with the German transfer pricing legislation?

German transfer pricing regulations assume that a hypothetical arm's-length test is applicable in most cases in the

Germany's approach to business restructuring issues is founded on different intellectual concepts than the OECD Guidelines.

absence of comparable third-party data. The test's mechanical application generally produces a positive value for the transfer as long as the restructuring leads to an increase in the receiving enterprise's expected profits. Taxpayers have the right to demonstrate that restructurings between third parties based on similar facts and circumstances (e.g. the transfer of a loss-making business) would not require indemnification; the related parties involved could refrain from applying the hypothetical arm's-length test. However, this demonstration must be based on explicit comparables, and not solely through the analysis of contractual or other rights of the two parties. As a result, in many circumstances, applying the German rules will imply a positive arm's-length payment while applying the OECD concepts would indicate that no payment is needed.

In many circumstances, applying the German rules will imply a positive arm's-length payment while applying the OECD concepts would indicate that no payment is needed.

Example 2: The OECD Guidelines add the perspective of the transferee to the equation for evaluating an arm's-length price for a potential transfer of property or activities. How does this compare to the double-sided valuation required by the German transfer pricing legislation?

The OECD Guidelines and the German transfer pricing rules take into account the interests of both parties. The German rules assume that the transferor's perspective is defined by the transferor's profit potential absent the transfer and that the transferee's perspective is defined as the transferee's profit potential after the restructuring. Other options (e.g. the right of one party to cancel or re-negotiate a contract, the ability to find a lower-priced third-party supplier) are not ordinarily taken into account and must be substantiated by extensive documentation to apply. Rather than simply requiring consideration of the options available to the two parties as standalone entities, the OECD Guidelines are more flexible and less prescriptive. Contractual rights and/or the ability to find alternative sources of supply may also be relevant to the analysis.

German tax law requires the valuation of a potential exit payment, and the mean of both values is deemed to be arm's length if no other value within the range is demonstrated to be more probable. In this regard, the German regulations may produce results (e.g. sharing of potential synergies realized by the transferee) that probably would not be realistic in a comparable negotiation between third parties. Contrary to the German

perspective, the OECD Guidelines acknowledge the complexity of the taxpayers' economic environment, which does not allow the appraisal of the facts and circumstances in a constricted legal framework.

Example 3: The OECD Guidelines state that the arm's-length principle does not and should not apply differently in the case of restructuring than in other transfer pricing contexts. How does this affect the treatment of goodwill and going concern value or profit potential?

The OECD Guidelines do not prescribe whether or not a payment is needed for goodwill and going concern or for profit potential. Instead, the OECD Guidelines set forth the core principle that a payment should be made in a related-party business restructuring only if a payment would be made in a comparable business restructuring among unrelated parties. If some or all of goodwill and going concern value would be paid for in a transaction among unrelated parties, a payment should be made in a related-party transaction. If no payment would take place among third parties, no payment should take place in a related-party business restructuring.

In contrast, the German base shifting rules are prescriptive. The German transfer pricing legislation implies that most restructurings in multinational groups are accompanied by a transfer of business activities that often constitute goodwill to be reimbursed by the transferee. The burden of proof is with the taxpayer to demonstrate otherwise. A shift in functions/assets is treated as a sale of a business, triggering a valuation based on the model of such a sale, which typically includes the value of goodwill and going concern. The rules include some exceptions that allow for a valuation of single assets instead of a transfer package including goodwill, in which case the German and OECD approaches are aligned. The German tax authorities once again extended these exemption rules in 2010.

Contributors:

Michael Freudenberg
KPMG in Germany
Email: mfreudenberg@kpmg.com

Matthias Kaut
KPMG in Germany
Email: mkaut@kpmg.com



Italy

Asserting Permanent Establishments

Business restructuring is increasingly discussed and challenged in tax audits in Italy. The Italian Tax Administration uses approaches that are generally aligned with the provisions of Chapter IX of the Organisation for Economic Co-operation and Development (OECD) Guidelines. In evaluating business restructuring issues, it is also important to consider the relationship between business restructuring, transfer pricing and other areas of taxation such as the analysis of indirect tax implications of deemed transfers of going concern.

In addition, the Italian Tax Administration has traditionally addressed business restructuring issues within the framework of permanent establishments, especially when entrepreneurial risks are changed by way of contract (e.g. when a full-risk distribution agreement is converted into a low-risk or commissionaire type of arrangement). While such change may lead to a reduction in expected profits, most taxpayers do not believe that an exit charge is needed for a change in the allocation of risk. However, operational changes may be negligible in this case, and intangible property (such as customer lists) is not transferred or only partially transferred since it is still used by the limited-risk distributor after the

conversion. In such cases, the Italian tax authorities may assert that the de-risked entity should be treated as an agent or permanent establishment.

Factors that are now central to the new OECD Guidelines' analysis of business restructuring have been historically considered by the Italian Tax Authority in evaluating whether a foreign entity was operating in Italy through an undeclared permanent establishment rather than in evaluating transfer pricing issues. These factors include the conduct of the parties, the allocation of decision-making powers between the legal entities, and the allocation of risks.

The Italian Tax Administration's position on permanent establishment is somewhat unusual and has led to significant controversy (e.g. the *Philip Morris* case). A subsidiary in Italy can be deemed to assume the role of a multiple permanent establishment, when core (and not auxiliary or preparatory) activities are performed on behalf of a number of foreign resident entities within the related group. The participation of representatives or employees of an Italian company in the conclusion phase of a contract of a foreign company may be regarded as an authority to conclude contracts on the foreign company's behalf.

The Italian Tax Administration has traditionally addressed business restructuring issues within the framework of permanent establishments.

The Italian Tax Administration's position on permanent establishment is somewhat unusual and has led to significant controversy.

Contributors:

Domenico Busetto
KPMG in Italy
Email: dbusetto@kstudioassociato.it

Gianni De Robertis
KPMG in Italy
Email: gianniderobertis@kstudioassociato.it



Japan

Interpreting Intangible Property Ownership – Japan versus United States

Controversy involving intangible property (IP) may be one of the most contentious areas of tax audits in both Organisation for Economic Co-operation and Development (OECD) and non-OECD countries. A key issue involves determining which entity owns the IP, assumes economic risks associated with the IP's development and thus has the rights to the resulting income. Conventional economic theory and traditional OECD and U.S. practice favor the entity that funds the IP development costs and thus bears the economic risk of such investments. Taxpayers often use this principle to separate ownership of the economic results of IP investments from the conduct of such intangible development – it is the entity that funds R&D and bears the economic risks that the R&D will or will not be successful that owns the economic results of the R&D under a contract R&D agreement, not the entity that actually carried out the R&D. However, tax authorities are often skeptical of such arrangements. As discussed below, the tax rules in Japan support a different concept of the economic ownership of IP and associated risks.

The Japanese interpretation of IP and its ownership

On June 25, 2007, an amended version of the Commissioner's Directive on Procedure for Confirmation of Transfer Pricing Methodologies to Determine the Arm's-Length Price (the "Japanese Guidelines") was released which discusses three types of IP:

- patents, trade secrets, and other items created through technical innovation
- know-how created through the experience of employees and other human resources in management,

front-end operations, production, R&D, sales promotion, and other business activities

- production processes, negotiation procedures, and trading networks relating to development, sales, financing, and similar activities (see Article 2-11 of the Japanese Guidelines).

Based on the Japanese Guidelines, the Japanese, OECD and U.S. definitions of IP do not differ significantly.

Nevertheless, Japan determines economic ownership of IP differently. According to the Japanese Guidelines (see Article 2-12), the Japanese tax authority examines IP by measuring each participating entity's contribution to the activities for formulating, maintaining or developing the IP itself. In this examination, the criteria considered include:

- making decisions
- conducting development activities
- bearing costs
- managing risk.

The Japanese Guidelines also state that a participating entity's degree of contribution should be reduced or not considered where the entity merely bears the costs of the IP development without other contributions.

The US and OECD rules require that the determination of who bears risks should be based on:

- the contractual relationship between the parties
- the conduct of the parties
- the financial capacity to bear the risk
- the decision-making authority.

Among these factors, the concept of contractual relationship between the related parties is absent in the Japanese rules. Further, the performance of actual development activities is not part of the US and OECD determination factors. These differences are due to the lack of a fully developed risk concept in the Japanese rules. The word “risk” hardly appears in the Japanese transfer pricing rules, and the economic ownership of IP by itself is not explicitly discussed in conjunction with the assumption of risk. Accordingly, the Japanese tax authority tends to rely on other underlying factors, such as performance of actual development activities, to determine the economic ownership of IP and its appropriate return.

Issues

The Japanese interpretation of economic ownership can create a disagreement between the two tax authorities of the countries in which the related parties reside. For example, assume that a Japanese company’s high value IP is acquired by a related US company. The

US company fully funds the Japanese affiliate’s R&D in accordance with an R&D service agreement that clearly specifies that under the terms of the contract, after the IP’s acquisition, the Japanese affiliate continues to undertake the actual R&D. The Japanese affiliate now pays the US company a royalty for the use of the IP for its manufacturing and sales activities within its territory. From the US perspective, the IRS is likely to expect a high royalty rate, as the Japanese affiliate is highly profitable. The Japanese tax authority, on the other hand, may argue that the Japanese affiliate retains true economic ownership (at least to a certain extent) because the Japanese company still performs the R&D. As a result, the Japanese authority may deem a lower royalty rate to be more appropriate.

Conclusion

When dealing with related-party IP transactions involving Japan, companies need to consider the Japanese rules for the interpretation of the economic ownership of IP, in addition to the OECD and US transfer pricing perspectives. If differences in approach to establishing the economic ownership of IP are expected to create controversy, the related parties need to seek the best option for international resolution through venues such as competent authority procedures or bilateral advance pricing agreements.

Contributors:

Daisuke Horiguchi
KPMG in Japan
Email: daisuke.horiguchi@jp.kpmg.com

Jun Igarashi
KPMG in the United States
Email: junigarashi@kpmg.com

Atsuko Kamen
KPMG in the United States
Email: akamen@kpmg.com

Yasuyuki Nishi
KPMG in the United States
Email: ynishi@kpmg.com



The Netherlands

Early Adopter of New OECD Concepts?

Dutch tax legislation provides no specific rules for business restructurings, except those for rollover relief. If the Dutch Revenue believes that transactions relating to business restructurings are not compensated at arm's-length, it bases its tax assessments on the generic arm's-length requirements set out in Section 8b of the Corporate Income Tax Act (CITA).⁷ This provision also imposes documentation rules for related-party transactions, requiring Dutch taxpayers to maintain sufficient documentation to support the arm's-length nature of their intercompany transactions.

The Dutch Ministry of Finance takes the position that any changes to the OECD Guidelines take effect automatically, which may imply that new Chapter IX is effectively already incorporated into the Dutch tax practice. The Dutch Ministry contributed to the current OECD text, and the Dutch Revenue is expected to adhere to it. However, while the OECD Guidelines are important in interpreting the arm's-length principle in the Netherlands, they are not part of Dutch tax law, and so their status may be described (alternatively) as an "influential view" in the principle's interpretation. In reviewing cross-border

internal business restructurings, the Dutch Revenue has asked Dutch taxpayers at least four questions:

- What is the underlying business rationale for the restructuring?
- Will something of value be transferred and are (risk-bearing) functions actually transferred?
- Can functional analyses of the taxpayer before and after the reorganization be provided (along with a factual comparison of them)?
- What other realistic options were available to the taxpayer at the time of entering into the transaction(s)?

The Dutch Revenue has also requested an assessment of the financial impact of the business restructuring, pre- and post-conversion. This may include a valuation of the transferred assets, risks and/or functions, and an indemnification in the case of contract termination. The Dutch Revenue generally also investigates the reorganization and closure costs of business restructurings. Alternative legal and/or economic arguments are available that taxpayers can effectively use in dealing with the Dutch Revenue.

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⁷ Wet op de vennootschapsbelasting 1969 (Corporate Income Tax Act 1969).

The Dutch Supreme Court has heard few specific business restructuring cases, and so Dutch case law provides only limited guidance. It is debatable whether the Dutch transferor should be compensated for a transfer of functions and risks (which are not a going concern or a separately identifiable asset), even if expected future profits decline as a result. A number of Dutch court cases, when interpreted together, suggest that compensation is not necessarily required in such cases, but this view is uncertain.

Regarding OECD Issue Note 4:

“Recognition of the Actual Transactions Undertaken,”⁸ the Dutch Revenue has limited ability to deny such transactions when assessing the Dutch tax consequences. It could only do so by claiming that the legal form does not reflect its material meaning (*schijn en wezen*) or that the so-called *fraus legis* doctrine applies. The latter may apply only if a transaction is performed solely for tax reasons and if, by doing so, the taxpayer acts in conflict with the objective and

purpose of Dutch tax law. We see no room for the Dutch Revenue to invoke *fraus legis* in a genuine business restructuring.

Finally, specific regulations cover cases where business restructurings include the cross-border transfer of the company’s effective place of management (and thereby the company’s tax residency). Specific rules also apply where a company ceases to be subject to tax in the Netherlands, for example, in the context of a business restructuring. The European Commission is challenging these rules in an infringement procedure, which may lead to a case before the European Court of Justice (ECJ). In one case, the Lower Court of Amsterdam has submitted preliminary questions to the ECJ on the compatibility of the freedom of establishment principle with the Dutch exit tax rules. The case concerns the transfer of a Dutch company’s effective place of management to the United Kingdom. The OECD business restructuring guidelines are not expected to have any bearing in this context.

Contributors:

Loek Helderman

KPMG Meijburg & Co in the Netherlands

Email: helderman.loek@kpmg.nl

Richard Slimmen

KPMG Meijburg & Co in the Netherlands

Email: slimmen.richard@kpmg.nl

Eduard Sporken

KPMG Meijburg & Co in the Netherlands

Email: sporken.eduard@kpmg.nl

Marc Temme

KPMG Meijburg & Co in the Netherlands

Email: temme.marc@kpmg.nl

⁸ Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment, September 19, 2008 to February 19, 2009. OECD Center for Tax Policy and Administration.



Spain

Improved Access to Double Tax Relief?

The Spanish tax authorities have traditionally treated certain “business restructuring” issues (e.g. the costs of closing or downsizing a plant) as domestic tax issues rather than issues of transfer pricing. Domestic legislation provides exclusively for general anti-avoidance principles, and the tax authorities’ arguments have generally focused more on disregarding expenses than on an analytical process such as that described in Chapter IX of the Organisation for Economic Co-operation and Development (OECD) Guidelines.

For example, the Spanish tax authorities have argued that certain restructuring expenses incurred by a Spanish entity, such as costs associated with closing operations, are non-deductible. The tax authorities have asserted that such costs are not beneficial to the Spanish entity and thus are not deductible as a simple matter of local tax law, particularly if the Spanish entity has high profits before the restructuring. The tax authority’s position is based on a general anti-avoidance principle: since the closure costs may not be beneficial, they should not be borne by the Spanish entity. Especially if the Spanish entity had profits before the restructuring was characterized as a low risk entity, or losses were due to over capacity with no possibility of expansion due to intra-group arrangements, tax authorities may argue that the costs associated with shutting down the operation would exclusively benefit the group as a whole and should not be borne by the Spanish affiliate.

At this point, the Spanish tax authorities have not publicly responded to the guidance in Chapter IX. However, domestic legislation specifies that the

OECD Guidelines are to be taken as interpretative norms. Even though Spain is unlikely to amend or develop its rules in response to Chapter IX, the new OECD Guidelines on business restructuring are likely to affect audits in Spain in two important ways as follows.

- In the past, there has been little sophistication in the analysis of exit charge issues by the tax authorities. Their arguments have been largely limited to legal discussions about whether certain expenses are beneficial and thus whether they qualify as legitimate business expenses. In the future, taxpayers (and tax authorities) can be expected to rely on the key concepts in Chapter IX in formulating their positions on exit charge issues, increasing both the number of issues that can be raised and the sophistication of the arguments presented.
- Taxpayers facing the disallowance of expenses under domestic law have had no recourse to international dispute settlement options under the mutual agreement procedures (MAP). Since adjustments have been typically based on domestic laws, taxpayers have not been able to benefit from MAP or arbitration processes to eliminate double taxation. By simply clarifying and confirming that business restructuring adjustments have to be based on Chapter IX, such adjustments become clearly an Article 9 (of the applicable Double Tax Convention) issue, thereby expanding double taxation protection available to taxpayers.

Even though Spain is unlikely to amend or develop its rules, the new OECD Guidelines on business restructuring are likely to affect audits in Spain in two important ways.

Contributor:

Montserrat Trape
KPMG in Spain
Email: mtrape@kpmg.es



United Kingdom

Chapter IX - Nothing Changes?

The stated position of HM Revenue & Customs is that the new Chapter IX of the Organisation for Economic Co-operation and Development (OECD) Guidelines does not change anything for UK taxpayers, and simply provides some useful clarification of the approach the UK authorities were already taking. They have also stated that they don't perceive Chapter IX as creating any additional documentation burden beyond what is already required of taxpayers, but it remains to be seen whether this will be the case on audit, particularly given the OECD emphasis on "options realistically available." What is more, it is clear that in the UK, Chapter IX will be used primarily as a guide to valuation rather than a determinant of whether there has been a taxable event in the first instance.

Companies restructuring their operations in the UK must consider a plethora of legislation, case law and practice when determining what, if any, tax implications there may be. In line with most other European countries the topics commonly encountered include:

- Permanent establishment risk, especially "dependent agent"
- Deemed disposal of intangible assets, especially when these are linked to contracts or specific IP rights
- Transfer pricing before and after the restructure (including re-evaluating debt capacity)

- Tax deductibility of restructuring costs
- Interaction with Controlled Foreign Companies rules, domestic anti-avoidance, withholding taxes and other potentially relevant provisions.

Interaction Between Capital Gains Legislation and Transfer Pricing

The UK domestic chargeable gains legislation is the starting point for determining whether there has been a disposal of an asset. The rather broad definition of assets and disposals in the legislation is supported by many decades of jurisprudence, as well as guidelines published in HMRC's series of tax manuals. It is this, rather than the OECD Guidelines or more general considerations relating to the shift of risks, functions and profit potential that determines whether any up-front charge is brought into account for tax purposes.

Once it has been established that a disposal has taken place between "connected persons," the legislation applies the arm's-length principle to determine disposal proceeds. At this point, the OECD guidelines in their broader sense, and Chapter IX in particular, come into play.

In the absence of a specific asset disposal it is still possible that the arm's-length nature of steady-state pricing following the restructure, or one or more of the other issues listed above, will be subject to scrutiny.

Companies restructuring their operations in the UK must consider a plethora of legislation, case law and practice when determining what, if any, tax implications there may be.

The stated position of HM Revenue & Customs is that the new Chapter 9 of the OECD guidelines does not change anything for UK taxpayers, and simply provides some useful clarification of the approach the UK authorities were already taking.

Tax Authority Approach

HMRC has an established track record of auditing business restructurings and its manuals provide guidelines to tax inspectors on the appropriate questions to ask and topics to explore. As a result, taxpayers often face quite predictable questions focusing on the economic context of the restructuring, the operational drivers (sometimes with an implied skepticism as to the “true” underlying motive), and the degree of functional change accompanying the restructuring. HMRC will for example often request a meeting with operational employees to establish what, if anything, has really changed.

Whilst enquiries often ask the “would” question (i.e. would a person acting at arm’s length have entered voluntarily into the arrangements without some form of compensation), one notable aspect of the written HMRC guidance is a strong preference to value transactions actually undertaken rather than to recharacterize

or ignore restructuring events. This approach is consistent with the wording of the new Chapter IX, and HMRC are on record as saying that they will only seek to recharacterize transactions in exceptional circumstances.

It is probably fair to say that the relatively open nature of the British economy is reflected to some extent in HMRC’s attitude to business restructurings. There is generally an acceptance that MNCs can and will restructure their businesses internationally, that the UK is sometimes a winner and sometimes a loser in this, and that the tax consequences of a restructuring should be considered based on hard facts rather than emotion. The UK government has also consciously changed its focus in recent years towards encouraging investment through a phased reduction in the headline tax rate (offset to some extent by a broadening of the tax basis).

Contributors:

Mike Bacon

KPMG in the United Kingdom

Email: michael.a.bacon@kpmg.co.uk

Stuart McDougall

KPMG in the United Kingdom

Email: stuart.mcdougall@kpmg.co.uk

Tim Sarson

KPMG in the United Kingdom

Email: timothy.sarson@kpmg.co.uk



United States

Evolving Views on Migration of Intangible Assets

While US transfer pricing regulations do not explicitly refer to “business restructurings”, the IRS is well aware that a change in circumstances (e.g. a shift in functions, a change in contract terms, a sale of intangibles) can significantly affect a US taxpayer’s profitability. The IRS can be expected to use the various tools and concepts contained in the US 482 regulations⁹ to impose charges. In particular, the IRS has focused on expanding the definition of intangibles to include non-traditional intangibles such as workforce in place and US goodwill and going concern value.

The Proposed and Temporary Regulations on Cost Sharing (“Temporary Regulations”) provide perhaps the clearest indication of the current IRS thinking on exit charge issues.¹⁰ In the Temporary Regulations, the IRS has broadened the concept of what has to be paid for from a specific set of intangibles to “any right, resource or contribution”. The Temporary Regulations have added three new pricing methods that focus on determining the value of a business enterprise rather than the prices of the individual intangibles owned by it:

- *The income method*, which determines the value of an exit charge based on the present value of profits associated with the transferred intangible/activities
- *The acquisition price method*, which determines the value of an exit charge for intangibles obtained through an acquisition based on the price paid for the acquired business enterprise

- *The market capitalization method*, which determines the value of an exit charge based on the implied value of the business enterprise as reflected in its stock price.

In addition to pursuing a broader definition of intangibles/exit payments, it will be interesting to see whether the IRS will also attempt to re-characterize the nature of the business relationship as established by the taxpayer. US guidance on such re-characterization is generally consistent with that in Chapter IX of the Organisation for Economic Co-operation and Development (OECD) Guidelines: the IRS should respect the transaction as established by the taxpayer as long as the established terms have a reasonable commercial rationale and the taxpayer’s behavior follows the form that it has established.

Moreover, while the IRS has attempted to re-characterize transactions in the past, it has consistently lost on such issues in court. That said, the Temporary Regulations impose specific restrictions on the form of a cost sharing transaction (e.g. by requiring perpetual and exclusive non-overlapping rights), and several of the new methods incorporated in the US regulations – particularly the market capitalization and acquisition price methods – provide little scope for reflecting specific business structures when determining exit charges.

The IRS has focused on expanding the definition of intangibles to include non-traditional intangibles such as workforce in place and US goodwill and going concern value.

Contributors:

Brian Trauman
KPMG in the United States
Email: btrauman@kpmg.com

Monique Van den Bremer
KPMG in the United States
Email: mvandenbremer@kpmg.com

⁹ US Treasury Regulations, as amended (26 C.F.R. Part 1), on section 482 of the Internal Revenue Code of 1986, as amended (26 U.S.C. §1 et seq.).

¹⁰ Treas. Reg. §1.482-7T.

New OECD Project on the Pricing of Intangibles

The OECD will consider outlining an overall framework or process for analyzing intangible-related transfer pricing issues. Such a framework may be similar to the OECD's multi-step framework for conducting a comparability analysis.

What's in Scope?

In 2011, the Organisation for Economic Co-operation and Development (OECD) will start a new project on the transfer pricing aspects of intangibles, which is intended to result in changes to the OECD Guidelines in this area. To kick off the project, the OECD's Working Party 6 (WP6) met on November 9, 2010 with industry and business representatives, as well as some representatives of non-OECD countries, to discuss the project's scope. The meeting was intended to give business commentators an opportunity to explain some of their arguments in relation to the scope of the project and for OECD WP6 delegates to obtain clarification on the arguments raised.

Scope of project refined

Based on comments received and discussions held at the January 25, 2011 meeting, the OECD's Committee on Fiscal Affairs approved the immediate start of a new project that will focus on the transfer pricing aspects of intangibles. This work is expected to produce an updated version of Chapter VI and possibly Chapter VIII of the OECD Guidelines, and will be undertaken by an ad hoc group of Working Party 6 (WP6 TPI). The OECD identified certain areas where work is needed including the following topics.

- *Framework for analyzing intangible-related transfer pricing issues.* The OECD will consider outlining an overall framework or process for analyzing intangible-related transfer pricing issues. Such a framework may be similar to the multi-step framework for conducting a comparability analysis, developed in paragraph 3.4 of the OECD Guidelines (i.e. a typical, non-compulsory process the use of which would be regarded as an accepted good practice).
- *Definitional aspects.* The OECD Guidelines do not currently define "intangibles" for transfer pricing purposes. The project will address key definitional issues related to Chapters VI and VIII. The specific approach to addressing these issues has not been determined, although several issues have been highlighted as warranting further consideration.
- *Specific categories of intangibles.* WP6 TPI has identified specific categories of intangibles that need specific guidance, including:
 - R&D
 - differentiation of intangible transfers and services
 - marketing and other intangibles and business attributes.
- *Transfers of intangibles.* WP6 TPI will develop guidance on identifying when a transfer of intangible exists and its form, as well as recharacterization issues.
- *Right of an enterprise to share in the return from an intangible that it does not own.* Clearer guidance will be provided concerning the right of an entity that is not the legal owner of an intangible to share in the additional return attributable to the intangible's development and exploitation.
- *Cost contribution arrangements (CCA).* Once sufficient progress has been achieved in Chapter VI, the OECD might partially review existing guidance on CCAs in Chapter VIII to the extent it relates to the sharing of costs and risks of developing, producing or obtaining intangibles.
- *Valuation.* The project will consider further guidance regarding the valuation of intangibles, including general guidance on:

- selecting the most appropriate method
- applying the five OECD-recognized methods
- comparability
- financial valuation methods
- aggregating intangibles for valuation purposes
- highly uncertain valuations
- other aspects.

The OECD Committee on Fiscal Affairs will invite selected representatives to attend part of its meetings and plans to release a discussion draft for public comment by the end of 2013.

A key issue is whether the definition of intangibles for transfer pricing purposes should be limited to intangible “property” that can be transferred separately from overall business operations, or whether the definition should extend to attributes that cannot be separated from the business, such as workforce in place, goodwill and going concern.

Key Issues Under Review

What is an intangible?

A key issue that the OECD will have to address is whether the definition of intangibles for transfer pricing purposes should be limited to intangible “property” that can be transferred separately from overall business operations, or whether the definition should extend to attributes that cannot be separated from the business, such as workforce in place, goodwill and going concern. The current OECD definition focuses on commercial intangibles, which are described as intangible property associated with commercial activities, such as the production of a good or the provision of a service, as well as an intangible right that is itself a business asset transferred to customers or used in the operation of business. The OECD Guidelines split commercial intangibles into two broad groups:

- Trade intangibles (e.g. patents and technology intangibles created through investments in R&D)
- Marketing intangibles (e.g. trademarks and trade names).

This definition has traditionally been viewed as covering intangible property, that is, intangibles that can be sold separately from the business and therefore

presumably excluding goodwill and going concern. However, the more recent OECD Guidelines on business restructuring explicitly discuss issues arising from the transfer of an activity as distinct from the transfer of either tangible or intangible property. By characterizing the transfer of an “activity” as the transfer of “something of value,” the OECD appears to reject the idea that transfer pricing in the context of a business restructuring is limited to the transfer of property. The OECD Guidelines note that the transfer of a “... functioning, economically integrated business unit” is the transfer of “... assets bundled with the ability to perform certain functions and bear certain risks.” A growing number of countries want to broaden the definition of an intangible for transfer pricing purposes. Therefore, the OECD is expected to at least consider broadening the definition of intangibles to cover attributes that cannot be transferred separately from the business as a whole, such as workforce in place, goodwill and going concern value.

Ownership and claim on profits

The question of who “owns” an intangible is a frequent source of controversy. This issue often arises where multiple legal entities have claims on profits that depend on the intangible. This issue has at least two dimensions. The first involves

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legal versus economic ownership. What factors determine which legal entity has economic (co-)ownership of an intangible (i.e. rights to the income resulting from the intangible)? Is it the entity that *carries out the activities* that lead to the intangible's development (e.g. R&D)? Or is it the entity that *pays for and bears the financial risks* associated with the development? Is there a necessary relationship between economic and legal ownership?

In this regard, legal ownership is often important in arm's-length dealings – it is often what enables an intangible owner to prevent other entities from infringing on its rights and eroding its ability to charge a positive price. On the other hand, tax authorities worry that legal ownership is too easy to manipulate and transfer among legal entities, and taxpayers often have an interest in separating legal ownership from economic ownership so that they can best meet both their commercial and tax interests.

The question of legal versus economic ownership is closely related to the second question: how to split profits between the legal entity that owns the underlying intangible and another legal entity that is responsible for making the investments needed to enhance and sustain that intangible. This issue arises when tax authorities and taxpayers try to distinguish between the contributions of a trademark and the contributions of the advertising and marketing expenditures needed to exploit the trademark – do the latter create a separate “marketing intangible” that has to be accounted for? Or should the OECD follow the recently revised US regulations, which distinguish between the ownership of the legal right to the trademark itself and the ownership of the contractual right given in a license to exploit that trademark under whatever terms are specified in the license agreement (e.g. specific geographic territory, exclusivity, duration of the license)?

A third question that the OECD is expected to address regarding the claim to profits generated by the use of intangibles is whether claims accruing to intangible development (e.g. R&D,

advertising and other promotional efforts) should go to the legal entity that carries out the function or to the legal entity that has funded the efforts. The current OECD Guidelines, including new Chapter IX, appear to favor the latter, provided that the funding entity has the requisite control, financial capacity, and particularly a clear contractual allocation of such claims. Commonly accepted economic theory also suggests that the entity that funds investments bears the risk rather than the entity that carries out the actual functions.

However, certain tax authorities, including those of China, tend to challenge the “artificial” separation between the function or carrying out of the activity and the funding of the activity. Japan adopts similar views; Japanese regulations list four factors to consider in determining the ownership of intangible property, and they explicitly state that the contribution of a legal entity will be deemed low when it merely bears the intangible property's development costs. As a result, this issue is another logical topic for the OECD to address as part of its intangibles project

The need for multi-year valuation/ pricing methods

The current OECD pricing methods focus largely on determining the correct prices within a given year without considering past or future events. But many intangible transactions span a number of years, and so the pricing approaches for determining the value of intangibles must often incorporate multiple years. This is not a new issue and many of the valuation techniques commonly used in economic analyses and financial statement valuations cover multiple years, with the period of time covered by the analysis determined by the life of the intangible asset at issue. Indeed, many such valuation approaches are already commonly used in transfer pricing analyses and accepted by tax authorities. However, the use of these methods and the coverage of multiple years raise a number of technical and procedural issues that are simply ignored in the current OECD Guidelines. Some of the more obvious issues include:

Certain tax authorities, including those of China, tend to challenge the “artificial” separation between the function or carrying out of the activity and the funding of the activity.

- The use of cash flow analyses rather than either financial statement or tax measures of current income
- Approaches to establishing the reasonableness of the forecasts used and the need (if any) to revisit them (make “commensurate with income adjustments”) if they prove wrong
- Dealing with intangible transactions in competent authority proceedings when the years before the competent authority cover only a subset of the years affected by the transaction at issue
- The relative weight given to comparables and comparable transactions and analyses based on economic logic, realistic alternatives, and subjective assessments about business decision-making.

Contributors:

John Neighbour
KPMG in the United Kingdom
Email: john.neighbour@kpmg.co.uk

Montserrat Trape
KPMG in Spain
Email: mtrape@kpmg.es

The complex supply chains that are used by many multinationals can create a wide range of transfer pricing issues. In this section, we cover four issues that are particularly relevant to multinational enterprises operating in Asia:

- recent State Administration of Taxation (SAT) training on auto industry issues, which provides useful insight into how

- the interaction between transfer pricing and customs, which is especially important in Asia due to relatively high duties
- centralized sourcing/procurement companies
- the treatment of location savings.



Insights from SAT Training on Automotive Issues

China's transfer pricing perspectives were made evident in a recent training session for key State Administration of Taxation (SAT) officials in July 2010. While this training focused primarily on the

automotive industry, the basic economic and transfer pricing issues discussed during the training extend to other industries and are important to understand from a supply chain perspective.

Potential for a China Market Premium

The prices of certain types of automobiles, especially imported luxury brands, are substantially higher in China than they are in the United States and many other parts of the world. The SAT believes that this may imply that a "China market price premium" should be taken into account in transfer pricing analyses.

The first step in evaluating this issue is to determine whether such a premium exists and, if so, whether it gives rise to higher profits than would otherwise be expected. While Chinese consumers face higher prices for many automotive brands, these higher prices are largely attributable to high duty rates on finished automobiles and high consumption taxes. Combined, these two levies may impose total direct taxes in excess of 50 percent of the underlying price. However, since transfer pricing analyses are principally concerned with the prices that are received by automotive companies, it is the prices paid after deducting duties and consumption tax that are relevant to the analyses.

The next step is to determine the reason for any differences between the market prices received by the automotive companies from sales in China as compared to sales elsewhere. The following two broad possible explanations were put forth to explain such differences.

- Automotive companies can avoid high duties by producing products locally. Since consumer prices in China are heavily influenced by the total landed cost of imported vehicles, local manufacturers may enjoy higher average market prices than prices received in other parts of the world where duties are lower. If a

car manufacturer can produce just as efficiently in China as elsewhere, these higher prices will lead to higher profits.

- The rapid increase in the demand for cars in China, coupled with limited current production capacity, may be creating a shortfall that is allowing for a substantial gap between production cost and prices. This may be particularly true for certain luxury brands that are in especially high demand and have fewer suppliers than in other parts of the world. This driver of profit margins is probably temporary.

Regardless of the cause, even if automotive companies can realize higher profits in China than in many other countries, such profits are likely to be temporary and to erode over time. Moreover, it is unclear whether such higher profits are realized by automotive companies in general or only by companies with specific economic attributes such as foreign luxury brands. In other words, it is not clear that non-luxury and local China brands achieve a China market price premium.

To the extent that the price premium does apply to locally developed brands on products produced in China, it would be a challenge to use intercompany transfer pricing to move this profit out of the country – and so this premium is likely to remain in China. However, to the extent that the price premium is limited to global brands in general or to global luxury brands in particular, the global brand owner probably has a claim on at least a portion of any higher profits associated with a China market price premium.

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It is relatively common for companies with market power to price-discriminate among different groups of customers so as to maximize their profit potential. In this case, it would be “arm’s length” for an automobile producer to charge a higher price on sales into China than into other countries to take advantage of the more favorable market conditions (including constrained supply for certain brands).

Finally, if automotive companies have to pay customs duties of up to 30 percent, the additional customs duties associated

with a higher import price will more than offset any income tax benefits. Therefore, the sheer magnitude of the direct taxes provides automotive companies with an incentive to charge as low a price into China as possible. This at least partially explains why certain automotive companies that sell finished cars into China often leave their Chinese distributors with very substantial profits (e.g. operating margins of 10 percent or more).

Marketing Intangibles

The extent to which marketing intangibles drive revenue and profits has been hotly debated in many countries. The root of the issue is that price and sales volume of a product, especially a consumer good, often depends on two factors:

- the use of a legally protected intangible, such as a particular patent or brand
- extensive advertising and other promotional efforts.

There are therefore two identifiable explanations for this profit, and often no clear way of reliably quantifying each factor’s effect on overall profitability. When the brand is owned by one legal entity and another carries out the advertising and marketing efforts, the two tax authorities involved are likely to take different positions. The tax authority of the legal entity that owns the legally protected right typically argues that the profits arise because of that intangible and that the local advertising would not occur and have no value if the legally protected intangible was not available. On the other hand, the tax authority of the legal entity that carries out the advertising and marketing efforts typically claims that the real source of value is the substantial investment that takes place locally and that the value of the legally protected intangibles would rapidly erode without continued advertising and promotional expenditures.

The SAT generally discounts the value of legally protected intangibles. Their premise is that successful global brands have limited (local) recognition when they are initially launched in China. By extension, the only reason a legally protected and globally recognized trademark has value

in China is because of the local affiliate’s advertising and marketing efforts. Even if the risks associated with this investment are shifted offshore through the terms of intercompany contracts, the SAT is still likely to argue that value accrues to the local affiliate performing the work rather than the entity paying the cost.

In evaluating whether local advertising and promotional expenditures give rise to a local marketing intangible, the key economic issue involves distinguishing between:

- marketing expenditures that are designed to *exploit* the brand name and therefore to maximize the profits that can be earned by selling products under that name, and
- the role of marketing and promotion expenditures in *creating* a brand name.

There is an inherent identification problem in determining whether the expenditures are being made because the brand is valuable or to make the brand valuable. A useful framework for such determinations is to consider two distinct intangibles:

- a legally protected trademark intangible
- a separate intangible associated with the right to exploit the intangible in a given market for a given period of time.

This debate played out during the SAT training session in the context of the automotive industry. This industry has specific brand-related attributes that made for interesting discussions on the following points.

- Global trademarks have a clear value. For example, consider cases in which an automotive original equipment

manufacturer (OEM) makes a specific model that is sold under its own brand and also under the brand name of a different OEM. Under such circumstances, the price commonly differs – often significantly – due to the OEMs' different reputations.

- Trademarks and product design in the automotive industry are closely related. A model's trademark positions the product in a particular way, and products sold under that trademark must incorporate appropriate design features. Toyota, for example, has positioned Lexus as its luxury brand and Toyota as its mainstream brand.
- Unlike in many industries, the investment in a particular model involves a commitment of a number of years: the years that it takes to develop the model and then the five or more years during which the model is sold. This timeframe imposes significant risks. Not only is there the inherent

uncertainty as to whether a particular model will appeal to consumers, there is the additional risk that the economic environment will change during the course of the model's life. For example, sales of a large SUV model may be adversely affected by an unexpected increase in gas prices during its life, which could conversely generate an unexpected spike in demand for smaller, more fuel-efficient models.

- There are both global and local relationships with marketing intangibles as well as technology intangibles. Some models are clearly targeted at the needs of specific countries, but, in many cases, a common vehicle platform and model is sold in multiple markets.

Such attributes provide taxpayers with compelling arguments to support attributing value to the underlying intangible. Automotive brands are global in nature and therefore depend



The SAT believes that local advertising and promotion creates marketing intangible value in China that has to be compensated.

on design and sales activities outside of China. As a result, success of the overall brand/product concept in China is made possible by functions and investments occurring outside of China. Second, there is substantial evidence about arm's-length behavior in licensing arrangements, which typically specify that brand ownership remains with the licensor (e.g. the automotive OEM), even when the licensee (e.g. the distributor or dealer network) is responsible for directing and funding local advertising, marketing and promotional efforts.

The key point is that the SAT believes that local advertising and promotion creates marketing intangible value in China that has to be compensated. Multinational companies that want to limit local profits in China need to develop a compelling argument that emphasizes the direct links between the functions performed and investments made outside of China to the brand's local success. The effort required to win this argument is much greater in China than in other OECD countries.

Technology Intangibles

Technology intangibles generally require continuous investment over time, and at least some of the work on developing technology intangibles often follows the re-location of manufacturing operations. One key question that arises is who bears the risks associated with the investments needed to maintain and develop technology, and who should realize the profits associated with such investments. The traditional OECD view is that the legal entity that is responsible for paying for the investment bears the risk and therefore should realize the rewards of R&D investments. Therefore, risks and rewards can be shifted from the legal entity that functionally performs the R&D to a different entity through a contractual re-allocation of financial responsibility. As such, a key foundation for any transfer pricing analysis is the examination of functions, assets and risks, and how they interact. Furthermore, it is important to distinguish between the legal entity that performs a specific function and the legal entity that pays for the function and bears the associated financial risk.

The SAT tends to equate functions and risks, and so it is reluctant to accept that a single-function entity should bear the risk of loss or that a legal entity with multiple functions can be treated as a low-risk entity. During the training session, the SAT questioned whether it should respect risk transfers for entities that carry out a diverse range of functions in China. The SAT also expressed specific reservations about contract R&D and limited-risk distribution operations. The SAT's position is that if the key skill sets and decisions are made in China, the resulting profits should remain in China. The SAT appears to have a bias that risk lies with the legal entity that carries out the functions and

owns the assets, rather than considering risk as something that can be shifted contractually.

This difference between the views of the OECD Guidelines and those of the SAT leads to key challenges for multinational companies that operate in industries that have a complex relationship between technology and the supply chain. Once again, the automotive industry provided a good context for exploring these differences. Consider the following attributes of technology in the automotive industry.

- Technology investment is a necessary "price of admission," but it generally does not contribute directly to excess profits (except in model design).
- Ongoing improvement, and thus continued spending on R&D, is imperative for both OEMs and first-tier automotive suppliers.
- The required investments in technology are large and cover a diverse range of different technologies, including basic materials technology (e.g. steel, coatings), automotive component technologies (e.g. batteries, engine), process technologies (e.g. robotics), and product design. These technology investments are made by both OEMs and first-tier suppliers, often in collaboration.
- The relationship between global and local considerations is complex. The major OEMs develop and use technology globally but then have to customize it to meet local needs.
- The development of a new model requires several years of up-front investment. Once this investment is

made, the automotive OEM and its suppliers are locked into that model for five years or more.

Due to such technology attributes, automotive OEMs and their first-tier suppliers will likely have complex technology-related transfer pricing issues in China. While there are some relatively simple supply chains that avoid technology transfer issues (e.g. sales of finished products, sales of kits that can be readily assembled into finished products), the more realistic long-term options generally involve more substantive manufacturing in China and local design activities to customize products for the Chinese market. Under such circumstances, some multinational companies may try to establish a contract manufacturing relationship in which the foreign-based technology owner provides the local China affiliate with risk-free access to necessary technology and sets transfer prices to capture any residual profits. When such an approach was discussed during the training session, the SAT was highly skeptical of transfer pricing analyses that treated the local Chinese entity carrying out complex or valuable functions as a low-risk entity.

In addition to challenges by the SAT, raw material and component sourcing flows put pressure on the contract manufacturing model. For example, many Chinese manufacturing affiliates source the majority of inputs from local Chinese suppliers. If the Chinese entity only purchases 10–20 percent of its components from related affiliates, there may be no reasonable way of building the value of the overall technology into the price of this limited number of

components. The Chinese manufacturer would generally become the key risk-taker and compensate the technology owner either through a royalty payment or by acquiring the rights to exploit the technology locally.

An alternative to contract manufacturing would involve two steps. First, the Chinese entity would have to gain access to technology that was developed and is owned by the parent company. The computation of such a buy-in payment is often controversial regardless of the taxing jurisdictions involved – and the SAT has not established much history in its approach to valuation. One way in which companies have avoided this issue is by paying a royalty that is broadly equivalent to the pro-rata cost of carrying out the required R&D. This generates approximately the same economic result as reimbursing R&D costs but does not involve a change in the ownership of the technology or the computation of a buy-in payment. Second, the China affiliate would have to pay for the cost of the ongoing development of technology, which would require an arm's-length markup to the extent the R&D function is performed by affiliates outside of China.

In summary, when it comes to transfer pricing for technology intangibles in China, there are no easy answers. Companies that decide to use a contract manufacturing approach should expect a significant challenge from the Chinese tax authorities. However, establishing a value for technology intangibles that satisfies the SAT and also appropriately remunerates the foreign-based owner may be just as contentious.

While there are some relatively simple supply chains that avoid technology transfer issues, the more realistic long-term options generally involve more substantive manufacturing in China and local design activities to customize products for the Chinese market.

When it comes to transfer pricing for technology intangibles in China, there are no easy answers. Companies that decide to use a contract manufacturing approach should expect a significant challenge from the Chinese tax authorities.

Impact of Joint Venture Arrangements

The most common business model for companies entering the China automotive market is through an equal joint venture. The SAT noted that the terms of the original joint venture are by definition arm's length, but asked about the implications when:

- pricing terms are included as part of the joint venture arrangement
- pricing terms change during the course of the arrangement.

The logical response to the first issue is that the overall terms of the joint venture arrangement are clearly arm's length and

so the key question is whether other elements of the arrangement are likely to affect the pricing terms for a specific transaction. For example, if one joint venture partner contributes capital and the other contributes technology, the technology may appear to have a price of zero, but that is because it is offset by the capital contribution and not because its market price is zero. Any specific price set in the joint venture arrangement is therefore potentially affected by other aspects of the agreement and not necessarily indicative of arm's-length pricing in a different context.

On the other hand, there are certain types of transactions in which the joint venture partners have an interest in maintaining an arm's-length price, and each partner is probably in a position to ensure that the terms are arm's-length. This is likely to occur, for example, when one of the partners sells components to the joint venture. The other partner would not want the components to be over-priced as this would erode its share of the joint venture profits. Further, the proportion of components sourced from one partner may change over time, making it difficult to incorporate the value of any bias into other parts of the joint venture arrangement. Therefore, even though this may be a controlled transaction, the two parties are presumed to act to protect their self-interest and thus ensure that the pricing is arm's length.

The second issue raised by the SAT dealt with changing the terms of an existing joint venture agreement. For example, assume a new model is licensed to the joint venture, creating an increase in

the trademark royalty rates for this and other models. In this example, the SAT was concerned that the foreign joint venture partner was using its leverage (i.e. providing access to a new model) to negotiate an increase in the trademark royalty rate.

The response to this issue is somewhat more complicated. The first question to ask is whether the foreign joint venture partner would have the same leverage in an unrelated setting. Thus, even if the joint venture was unrelated to the foreign firm, it could insist on a change in pricing terms as a condition for allowing access to the new model. If the foreign partner would have the same leverage in a third-party arrangement, then the change in pricing should be viewed as arm's length. The key practical issue is that changes in pricing terms are often accompanied by a wide-ranging re-structuring of terms, thus requiring a case-specific analysis of whether the pricing is affected in some way that is not consistent with a stand-alone arm's-length deal.

Conclusion

Given the relatively low cost of local manufacturing and a growing domestic consumer base, China is poised to absorb an increasing share of the physical supply chain. So perhaps it is not surprising that the SAT wants to focus attention on the performance of physical functions at the expense of intangible contributions and assumption of underlying risks. The stage

is now set for controversy as multinational companies based in other OCED countries struggle to satisfy tax authorities in their home countries who place relatively little weight on the performance of routine functions. Only time will tell how a balance is ultimately achieved.

Contributors:

Cheng Chi
KPMG in China
Email: cheng.chi@kpmg.com

Jerry Klopfer
KPMG in the United States
Email: jklopfer@kpmg.com

Converging Customs and Transfer Pricing Concepts

Overview

In theory, transfer pricing and customs rules seek to impose a similar standard on related-party pricing – prices should reflect those that would exist if the parties were unrelated. However, there is a long history of tension between tax and customs administrations. The relevant rules are governed by different international ruling bodies (the World Trade Organization (WTO) for customs, the Organisation for Economic Co-operation and Development (OECD) for transfer pricing) and have different objectives. Tax administrations generally have an incentive to minimize the cost of goods sold and thus import prices. Conversely, customs administrations generally have an incentive to maximize the cost of goods sold and thus import prices, resulting in higher dutiable value and processing fees. Other differences include:

- different sets of regulations
- different filing time periods (generally entry-by-entry for customs versus annual tax returns)
- different methods for determining an arm's-length price
- different presumptions as to the key determinants of comparability (product/industry for customs versus functional equivalence for tax).

The challenge for multinational enterprises (MNE) lies in reconciling these differences to achieve, support and document an arm's-length result in a way that satisfies the general principles of both sets of rules. Recent developments at the World Customs Organization (WCO) and with US Customs suggest that there is some movement towards convergence in this regard.

The challenge lies in reconciling differences in customs and transfer pricing regimes to achieve, support and document an arm's-length result in a way that satisfies the general principles of both sets of rules.

Background

Transfer pricing rules say that “a controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result).”¹¹ In reaching this conclusion, the tax transfer pricing rules often look at not only the transaction itself but also the various functions underlying it. Such functions include R&D, manufacturing, sales, marketing, distribution, and services such as back office activities.

The customs value of imported goods is generally its transaction value, which is the price actually paid or payable for the goods when sold for export to the country of importation, provided that the buyer and seller are not related. When they are related, the transaction value may be acceptable for customs purposes provided that the *circumstances surrounding the sale* indicate that the relationship did not influence the price.

Table 1 compares the customs “circumstances of sale” test methods to OECD methods.

¹¹ Treas. Reg. §1.482-1(b)(1).

Table 1

Circumstances of Sale Test Examples and Methods	Analogous OECD Methods
<ul style="list-style-type: none"> • Normal pricing practices of industry (NPPI) 	<ul style="list-style-type: none"> • Potentially any OECD method
<ul style="list-style-type: none"> • Sales to unrelated buyers (UB) 	<ul style="list-style-type: none"> • Internal Comparable Uncontrolled Price (CUP)
<ul style="list-style-type: none"> • All costs plus profit equal to seller's overall profit for same class or kind of goods (CPP) 	<ul style="list-style-type: none"> • Profit split and/or Unspecified Method

Source: KPMG International 2011

If the importer cannot demonstrate that prices are arm's length using the above methods and thus fails to satisfy the circumstances of sale test, then

the customs regulations require that alternative methods of appraisal be applied in the order shown in Table 2.

Table 2

Customs Alternative Method Hierarchy	Analogous OECD Methods
<ul style="list-style-type: none"> • Transaction Value of Identical or Similar Goods 	<ul style="list-style-type: none"> • External CUP
<ul style="list-style-type: none"> • Deductive Value 	<ul style="list-style-type: none"> • Resale Price Method (RPM) or Comparable Profits Method (CPM)/Transactional Net Margin Method (TNMM) with buyer as tested party
<ul style="list-style-type: none"> • Computed Value 	<ul style="list-style-type: none"> • Cost Plus Method or the CPM/TNMM with seller as tested party
<ul style="list-style-type: none"> • Fallback Method 	<ul style="list-style-type: none"> • Unspecified method

Source: KPMG International 2011

Toward International Convergence

As the following examples show, certain countries have tried to integrate transfer pricing and customs over the past several years.

- In 2006, the Canada Revenue Agency and the Canada Border Services Agency issued a joint circular which was meant to discuss the appropriate use of tax transfer pricing methods to support customs valuation requirements but in fact focused more on the differences between the two approaches.
- In 2007, Australia established a process whereby importers could seek a valuation advice ruling related to transfer pricing. However, the Australian Customs & Border Protection Service (Australian Customs) policy in respect of this process was only finalized in 2009. While the importer is required to demonstrate the appropriateness of the OECD transfer pricing method to the customs transaction value method, Australian Customs has accepted transfer pricing

documentation and APAs as part of the documentation required to support the circumstances of sale test.

- In 2008, Korea introduced the advance customs valuation arrangement (ACVA). The ACVA represents an agreement between the taxpayer and the Korea Customs Service (KCS). In support of the ACVA application, the KCS has prescribed documentation requirements and, if agreement is reached regarding transfer pricing methods to support customs value, importers will not be audited for customs valuation for a period of three years.

More broadly, joint OECD/WCO Transfer Pricing conferences were held in 2006 and 2007 in Brussels. Participants sought to establish ways in which certain transfer pricing methods could be used to satisfy the circumstances of sales test, thus allowing the use of transaction value between related parties.

In 2008, a focus group was formed on transfer pricing at WCO headquarters in Belgium. The focus group comprised several delegates from the WTO, WCO, OECD, customs and tax administrations, and the private sector. Key recommendations related to transfer pricing included:

- determining the feasibility of utilizing certain methods under the OECD Guidelines for customs valuation purposes or examining the circumstances of sale test
- exploring the possibility of utilizing APAs adopted by tax authorities for purposes of examining the circumstances of sale
- determining whether or not transaction value applies when the price paid or payable is subject to a future adjustment and determining the effect of post-importation transfer price adjustments (upward or downward) made to satisfy tax authorities.

As part of these efforts, two proposed case studies were introduced at the WCO's Technical Committee on Customs Valuation (TCCV) in 2009. These case studies address the use of certain transfer pricing methods to satisfy the circumstances of sales test. While the case studies have not been formally approved or adopted by the WCO TCCV to date, they may signal the direction and mindset of various member-country customs valuation branch delegates who regularly attend the TCCV meetings.

Transactional net margin method case study – Importer/buyer as tested party

The key interest of customs administrations is to protect against the undervaluation of products exchanged in related-party sales. Thus customs administrations that agree to utilize certain OECD methods are generally more interested in the results of the exporter/seller as the tested party, rather than the importer/buyer. In this proposed case study, the tested party is the importer/distributor, which is a potentially major breakthrough.

This proposed case study seeks to demonstrate the acceptability of transaction value by showing that the transfer price is settled in a manner consistent with the normal pricing practices of the industry circumstances of sales test method. The proposed case study contends that Article 1.2(a) of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade "allows customs to conduct an analysis of profitability of similar companies in the industry" and that "this is achieved by utilizing the results of a transfer pricing study prepared by an outside accounting firm."

The OECD method employed in the transfer pricing study is the TNMM and the importer's profitability (in this case, net profits) is based on sales in the country of importation.

Customs considers the functions and risks of the importer as a low-risk distributor, as well as the comparable inter-quartile operating profit range of companies that perform similar functions, incur similar risk, and use similar intangible assets. The functional analysis involves evaluating the roles performed by the parties, such as R&D, management, warranty administration and advertising, transportation and warehousing, to determine the comparability between the importer/buyer and other, similarly situated companies.

The proposed case study indicates that operating profits should be allocated among the related parties to reflect the functions they perform. Accordingly, the proposed case study finds that the functional analysis is clearly among those circumstances surrounding the sale that could be considered under Article 1.2.

The study's authors indicate that the wording of Interpretive Note to Article 1.2(a) of the Agreement was broad enough to permit the use of OECD transfer pricing guidelines in determining whether the relationship influenced the price. The commentary to the study acknowledges that the Interpretative Note provides

examples to illustrate that the relationship has not influenced the price and that other factors may be relevant. Therefore, according to the proposed case study, the language of Article 1.2 is broad enough to allow the use of a transfer pricing analysis prepared under the OECD Guidelines.

However, the proposed case study relies heavily on traditional customs perspectives and gives considerably more weight to comparables involving companies that sell merchandise of the same class or kind. For example, the tax transfer price study referenced in the proposed case study included comparable companies from the electrical apparatus and equipment and electronic parts and equipment industries – companies that sell goods of the same class or kind as the imported goods. Because the operating margin of the importer/tested party fell within the arm's-length range of comparable companies, customs could confirm that the importer's selling price (or operating profit) took "into account the cost of the product throughout each step in the sale from the manufacturer (seller/exporter) to the consumer. In other words, the operating margin comparison between [the importer/tested party] and the other comparable companies, as stated in the transfer pricing study, could be considered to be consistent with the market as a whole, thereby demonstrating that the price between the [importer and seller] could have been settled in a manner consistent with the normal pricing practices of the industry."¹²

Caveats to the proposed case study included the need for:

- comingling profits in the TNMM calculation with non-importing activities such as after-sales service
- selecting suitable comparables
- granting customs access to the information provided by companies to tax authorities
- affording greater reliance to bilateral APAs

- recognizing that the applicability of the TNMM method can vary depending on the facts of each case.

Cost plus method case study – Seller/exporter as tested party

This proposed case study evaluates whether a transfer pricing study relying on the OECD TNMM satisfies the circumstances of sale test using the all costs plus a profit (CPP) method example. The key issue in this regard is that the CPP, as generally applied by customs authorities, looks at internal measures of profits, while the CPM/TNMM often relies on the profits of external comparables. Accordingly, the CPP compares the seller's profit to the profit of the related firm's overall profit (i.e. an internal comparison), while the OECD TNMM evaluates profits of comparable external companies.

The functional analysis in the submitted transfer price study demonstrated substantial similarity between the exporter (tested party) and five sellers from the same country of export, who sell goods of the same class or kind to unrelated buyers. Among other things, the analysis showed that the functions performed were comparable in terms of their frequency, nature and value. The analysis also demonstrated comparability in the inventory levels, significance of fixed assets, contractual terms of sale, and risks. Furthermore, the exporter's cost plus a profit markup percentage fell within the inter-quartile range of the comparable sellers.

As such, the study established that prices charged by the seller to the importer were adequate to recover all costs plus a profit. However, it could not be established that the profit from these transactions was representative of the firm's overall profit over a representative period of time.

Nevertheless, the proposed case study concludes that the seller/exporter prices are adequate to recover a profit that is representative of a comparable unrelated seller's profit realized over a representative period of time (i.e. the relevant fiscal year) in sales of goods of the same class or kind.

¹² CFR 152.103 (l)(1)(ii)

Therefore, the transaction value in respect of the imported goods may be acceptable for customs purposes.

In support of this apparent deviation from an internal to an external profit comparison, the proposed case study cites Interpretative Note to Article 1.2¹³ and includes the following key arguments.

- Customs administrations should be prepared to examine relevant aspects of the transactions, including the way in which the buyer and seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price. This involves a complete analysis of the transaction in question and uncontrolled transactions in order to determine whether the relationship influenced the price. The examination of those aspects must always have a comparability purpose, since this is the only mechanism authorized by the Agreement for determining whether the relationship influenced the price.
- The language of the Interpretative Note to Article 1.2 is broad enough to permit a functional analysis and a comparison of contractual terms, economic circumstances, and business strategies (in the context of a comprehensive transfer pricing study) under the more detailed rules of the OECD Guidelines in determining whether the relationship influenced the transaction value.
- The second example of the Interpretative Note to Article 1.2 (i.e. the CPP test) provides guidance on the type of examination of the circumstances of sale required by the Agreement. It does not require that the methodology used by the importer in examining the circumstances of sale be identical to the one used for purposes of the example. Otherwise, the Interpretative Note would have used more prescriptive language rather than terms such as “as an example” and “as a further example”.

Importantly, the proposed case study argues that the use of external comparables within the context of the CPP example is:

- not “arbitrary or fictitious, being, therefore, consistent with the preamble of the Agreement”
- generally consistent with the process of examining the “normal pricing practices of the industry”
- supported by the Interpretative Note to Article 6 of the Agreement which allows the use of external comparables,¹⁴ even though this Note is directly applicable in the context of paragraph (a) of Article 1.2: “Taking into account that a treaty shall be interpreted in accordance with the ordinary meaning to be given to the terms of the treaty in their context, the provisions of Article 6 and its Interpretative Note are part of such context and, therefore, provide guidance of interpreting and applying Article 1.2.”

In summary, this proposed case study (which the WCO has not approved or adopted) refers to the OECD Guidelines’ TNMM, and among other things, states that “the cost plus markup of the supplier in a controlled transaction should ideally be established with reference to ... the cost plus markup that would have been earned in comparable transactions by an independent enterprise [which] may serve as a guide.” Therefore, the proposed case study supports that the use of the OECD TNMM is consistent with the examples of the Interpretative Notes and with the objective and purpose of the Agreement itself.

¹³ Interpretative Note 1.2 to the Agreement

¹⁴ Article 6 concerns the use of an alternative customs valuation method - computed value. The interpretative note to Article 6 states that “where the producer’s own profit and general expenses are not consistent with those usually reflected in the sales of goods of the same class and kind as the goods being valued which are made by producers in the country of exportation for export to the country of importation, the amount for profit and general expense may be based upon relevant information other than that supplied by or on behalf of the producer of the goods.”

Recent developments suggest that opportunities are opening to use tax transfer pricing methods and studies to support the customs circumstances of sales test.

Looking Ahead

Recent developments suggest that opportunities are opening to use tax transfer pricing methods and studies to support the customs circumstances of sales test. (Similarly, a customs study can often be adapted to support transfer pricing from an income tax perspective.) But this has to be done with care and with due deference to issues that are important under customs rules.

While an importer's documentation that its prices are arm's length from a customs perspective should be similar to its tax transfer pricing studies, the customs transfer pricing study should be written in language appropriate for customs administrations, rather than tax administrations, and refer to the relevant customs regulations and requirements. The customs transfer pricing study should provide a clear road map to the customs

authority, explaining why and how the results of the OECD methods illustrate and demonstrate that the circumstances of sales test is satisfied.

Similar to a tax transfer pricing study, the development of a customs transfer pricing study should include an analysis of the parties' functions and risks, a review of the facts and circumstances surrounding pertinent inter-company transactions (including non-dutiable but related intangible and services transactions), and the selection of comparables. Key to the comparable set are functionally equivalent companies that buy or sell the same class and kind of goods as the importer, with an emphasis on the selection of competitors. Also, similar to a tax transfer pricing study, a customs transfer pricing study should discuss the selection of the appropriate OECD and customs valuation methods.

Customs and Transfer Pricing Challenges – Asia

From a customs perspective, Asia creates unique challenges for two reasons. First, duties in some Asian countries can be quite significant, and successful supply chain planning requires balancing customs and transfer pricing requirements. Second, the level of transfer pricing experience of customs and revenue authorities varies dramatically across Asia. The region includes countries that have only recently adopted OECD-based transfer pricing rules and WTO-based customs rules. In some jurisdictions, discussions about harmonizing the valuation principles of the two regimes have not yet begun. However, the sophistication of the authorities in developing Asian countries is rapidly increasing.

risk. This is especially true if they are using the TNMM to test whether their prior year's operating income was within an arm's-length range and then using a year-end adjustment to bring their pricing within a specified range if necessary. Year-end adjustments related to imported goods generally have direct customs implications. In fact, retroactive price adjustments have been one of the most common areas of contention in Asia from a customs perspective. Many multinational enterprises in Asia have been assessed back duties and penalties for failing to declare to customs the excess profits remitted to their parent entity in accordance with their transfer pricing policy. Such a remittance may take the form of, for example, a debit note for goods purchases, a royalty or a management fee; each type of remittance can create outstanding customs liabilities for the payee.

The options for dealing with retroactive transfer pricing adjustments are often limited. In a number of countries in Asia, a formal mechanism for notifying customs authorities of such transfer pricing payments has not yet been established. In some countries the only option available to an MNE making such adjustments is to make a voluntary disclosure to Customs

As the focus on transfer pricing has increased for Asian tax authorities, many MNEs have become more proactive in managing transfer pricing for income tax purposes. In doing so, they may have inadvertently increased their customs risk.

As the focus on transfer pricing has increased for Asian tax authorities, many MNEs have become more proactive in managing transfer pricing for income tax purposes. In doing so, they may have inadvertently increased their customs

authorities every time a retroactive price adjustment is made – an administratively onerous task. Further, taxpayers are normally reluctant to adopt this approach as making voluntary disclosures is usually associated with non-compliance and could attract greater audit scrutiny from customs authorities.

One approach to dealing with this issue is to focus – from an income tax as well as a customs perspective – on whether prices are *set ex ante* on an arm's-length basis. Doing so can mitigate or eliminate the need for retroactive adjustments and thus greatly reduce this customs exposure. Moreover, properly managing customs and transfer pricing requirements not only mitigates risks of exposure from the authorities but also can uncover significant savings opportunities, particularly in countries with high duty rates. Doing this effectively, however, requires an understanding of customs as well as transfer pricing requirements; it is not uncommon to encounter customs officers who are unfamiliar with the OECD Guidelines. Thus, a transfer pricing policy written solely to address the OECD requirements, without considering the WTO methods, may not be readily considered by customs authorities

as sufficient to support an importer's declared values. Moreover, Asian customs authorities commonly monitor historical related-party prices to establish informal benchmarks, which they then use as a basis for the prices of future imports. In the event that declared prices fall below these informal benchmarks, Customs may require further explanations from importers.

Asian customs authorities are becoming increasingly sophisticated and areas of coordination between customs and tax authorities continue to broaden, particularly in terms of information-sharing and joint audits.

Despite these challenges, Asian customs authorities are becoming increasingly sophisticated and areas of coordination between customs and tax authorities continue to broaden, particularly in terms of information-sharing and joint audits. However, given the inherent conflict between the transfer pricing objectives of customs and tax authorities, taxpayers need to ensure that their transfer pricing studies and policies comply with both local transfer pricing regulations and the WTO valuation rules.

Customs and Transfer Pricing Challenges – United States

There is positive momentum for using certain IRS arm's-length methods to support intercompany customs declarations in the United States. The US Customs and Border Protection administration was the chief architect of WCO Commentary 23.1¹⁵ on the use of transfer pricing studies. The International Chamber of Commerce has created a working group to develop detailed guidelines for both customs administrations and importers. Among other things, the customs-centric guidelines would include the development of comparable sets and rules for aggregating transactions (customs requires transactional analysis), dealing with intangibles, and addressing post-importation upward/downward adjustments.

In addition to its international leadership, US Customs issued several favorable headquarter rulings during 2010 where the related-party transaction value

was held to be arm's length based in part on the results of a Section 482 contemporaneous study.

In ruling HQ HO29658 (December 2009), US Customs accepted the transfer price where the CPM method relied on the US importer/distributor of automobiles and parts as the tested party. While numerous compelling arguments were presented to US Customs, including research on the automobile industry's pricing practices, perhaps the most persuasive factor was the existence of a bilateral advance pricing agreement – the review and negotiation of a fair price by a foreign tax authority in the context of a bilateral APA is compelling evidence for an importing country's customs administration.

In ruling HQ H037375 (December 2009), the importer, a distributor of medical products and devices, submitted a transfer pricing study that utilized the OECD resale price method, with the

¹⁵ Adopted in October 2010, WCO Commentary 23.1, Examination of the expression "circumstances surround the sale" under Article 1.2(a) in relation to the use of transfer pricing studies (pending final approval by the WCO general assembly).

Compliance-minded importers seeking certainty may consider obtaining binding valuation rulings from US Customs. When pursuing such a ruling, the importer should meet with US Customs early in the process to make sure the study addresses US Customs' issues.

importer as the tested party. The study analyzed the distribution gross margin of the importer, which allowed the importer to recover its operating costs and to earn an arm's-length profit based on the functions performed, assets used, and risks assumed. US Customs noted that the importer must have "objective evidence" of how prices are set in the relevant industry in order to establish the "normal pricing practices of the industry" in question. However, US Customs found that the transfer pricing study's comparison of the importer and the other comparable companies was consistent with the market as a whole. Thus the study demonstrated that the prices were settled in a manner consistent with the normal pricing practices of the industry. This ruling suggests that US Customs may have effectively expanded its previous, conservative standard by allowing a transfer pricing study, rather than a trade journal, to provide objective evidence.

Compliance-minded importers seeking certainty may consider obtaining binding valuation rulings from US Customs. When pursuing such a ruling, the importer should meet with US Customs early in the process to make sure the study addresses US Customs' issues. For example, unlike traditional transfer pricing studies for tax purposes, US Customs emphasizes that comparable companies selected in the transfer pricing study should sell (or distribute) goods that are the "same class and kind as the imported merchandise." In other words, US Customs may not agree that objective evidence was provided merely on the basis of functional equivalency if those comparable companies do not sell goods of the same class or kind. Therefore, the selection of comparable companies is a critical

factor in demonstrating to Customs that the circumstances of sale indicate that intercompany prices were established in accordance with the industry's normal pricing practices. Involving US Customs in the comparable selection process may streamline the process and increase the probability of a favorable arm's-length finding (US Customs recently indicated that ruling decisions may be provided in as few as 90 days).

Regardless of an importer's appetite for obtaining a binding valuation ruling, a US Customs contemporaneous transfer pricing study may eliminate customs penalty risk. While the IRS and US Customs penalty regimes differ, a carefully coordinated documentation study may satisfy both agencies' contemporaneous documentation requirements, as both require controlled importers to document the arm's-length derivation of declared customs values. Like IRC Section 482, and regardless of dutiability, importers can be penalized if US Customs determines prices are not arm's length where no such customs contemporaneous documentation exists. While an importer may not rely exclusively on its Section 482 documentation study to satisfy US Customs' arm's-length documentation requirements, most of the information in the study can be utilized in a US Customs documentation study.

In summary, US Customs' policy regarding the use of economic principles adopted by the IRS to support an arm's-length price is nascent. Importers should consider seeking greater customs certainty through the ruling process. They should also synchronize the development of their contemporaneous documentation studies for tax and customs purposes.

Contributors:

Alex Capri
KPMG in Hong Kong
Email: alex.capri@kpmg.com

Tony Gorgas
KPMG in Australia
Email: tgorgas@kpmg.com.au

Kim Jarrett
KPMG in New Zealand
Email: kmjarrett@kpmg.co.nz

Todd Smith
KPMG in the United States
Email: trsmith@kpmg.com

Transfer Pricing Aspects of Realizing Benefits from Centralized Purchasing

The supply chains of many multinational enterprises (MNE) commonly have a centralized purchasing/sourcing function. Such procurement companies have been used to capture lower prices by consolidating the purchasing power of multiple affiliates and reducing the number of suppliers, providing for more effective quality control, developing more efficient currency risk management, and improving relationships with and control over suppliers.¹⁶ In some cases, such centralized sourcing affiliates provide procurement services without taking direct title to raw materials or product; in other cases, they purchase raw materials and/or products and resell them to other affiliates in the group.

Asia is a common location for such purchasing entities as more MNEs use low-cost, third-party manufacturers to source product directly or as they establish their own manufacturing operations that in turn need to source required raw materials and components from the region. Competition in terms of price and quality has forced European and American MNEs to source from Asian suppliers instead of continuing to purchase products from existing European and American suppliers.

Once the decision to source products in Asia is made, a local sourcing company is often established for reasons that range from the simple need for geographic proximity and the ability to operate in the same time zone to more fundamental requirements arising from the need for local language skills and familiarity with local business practices and regulatory requirements.

Establishing a local sourcing company creates transfer pricing issues. These issues can be complex and controversial if the purchasing company is viewed as a strategic component of the supply chain that contributes significantly to the performance of the group. The potential for controversy is particularly great if the procurement company's contributions to profits are relatively large in relation to the level of people and physical resources that are employed in the purchasing company. Not surprisingly, the likelihood of challenges by tax authorities increases when such purchasing companies are located in jurisdictions with favorable tax rates.

Competition in terms of price and quality has forced European and American MNEs to source from Asian suppliers instead of continuing to purchase products from existing European and American suppliers.

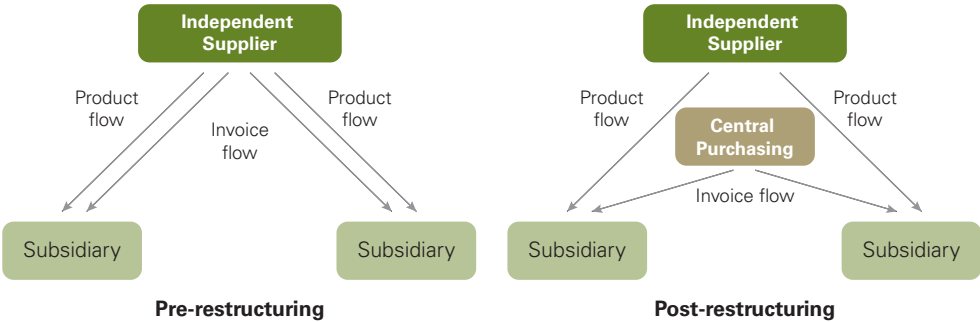
¹⁶ In this section, the terms "procurement company," "sourcing company," and "purchasing company" are used interchangeably.

What is Centralized Sourcing?

A centralized sourcing company purchases products or materials for the benefit of group companies. Figure 1 shows a typical product flow and invoice flow before and after a restructuring. Invoice flows for products and fees for

the central purchasing activities may deviate depending on business needs or regulatory requirements. (This figure illustrates a buy-sell structure; MNEs also have sourcing companies that operate on a services model.)

Figure 1



Source: KPMG International 2011

A wide range of different functional and risk profiles may exist within the overall transactional structure. At one extreme, a sourcing company can simply execute on contracts or sourcing arrangements that have been set up by the affiliates that they are supplying. Such an execution function may involve only limited order processing/facilitation capabilities; in some cases, order execution may involve more fundamental requirements, such as using a detailed knowledge of the discount rules offered by different suppliers to place orders in a way that secures the lowest possible price. At the other extreme, a sourcing company

could manage an extensive procurement process that involves activities such as tracing materials through complex supply chains that may have several different third-party manufacturers, carrying out required factory inspections and quality control, mixing and matching products supplied by different suppliers, and selecting suppliers.

Table 3 illustrates these two extremes by comparing a “strategic” sourcing company that carries out a diverse range of functions with a “transactional” sourcing company that simply executes on pre-established contracts.

Table 3: Strategic vs. Transactional Sourcing

	Strategic Sourcing	Transactional Sourcing
Objective	Establish and maintain long-term relationships between buyers and suppliers	Process transactions according to pre-established contracts
Primary Function	Supplier selection and contract negotiation	Place orders with controlled sellers. Little or no shopping among sellers involved
Impact	Helps to reduce the cost of goods sold	Routine administrative skills
Skills Required	Data analysis, contract negotiation, and relationship-building	Virtually none
Nature	Non-routine work	Routine work

Source: KPMG International 2011

OECD Guidelines – Applying the Arm’s-Length Principle

The price paid for the activities performed by or products purchased from a centralized sourcing company should reflect the arm’s-length principle; that is, the price should be set at the same level as would be expected had the transaction taken place between two unrelated parties. Under the OECD Guidelines, such intercompany pricing can be determined through the use of either:

- *Traditional transactional methods*, such as comparable uncontrolled pricing (CUP), the resale priced method, or the cost plus method, or
- *Transactional profit methods*, such as transactional net margin method (TNMM) or transactional profit split method.

As discussed below, the choice among methods and how they are applied can be a significant source of dispute between taxpayers and tax authorities. At issue is whether the transfer pricing should reflect either:

- the value that the sourcing company brings to the supply chain (the position of many taxpayers)
- a reasonable profit on the operating expenses (excluding the cost of purchased products) incurred in carrying out the sourcing activity (the position of many tax authorities).

The new OECD Guidelines on business restructuring should be considered in determining whether value creation or operating expenses should drive

the analysis of intercompany pricing for sourcing companies. Key concepts introduced by this guidance are as follows.

- *More emphasis on the importance of legal agreements and related documentation.* Consequently, it is important to ensure that the restructuring is reflected in documentation and that the legal agreements between group entities are arm’s length.
- *More emphasis on risk.* While the OECD Guidelines state that tax authorities should respect the allocation of risk as established by the taxpayer, this statement is qualified with the caveat that the *ex ante* contractual allocation of risk must be arm’s length.
- *More emphasis on “reasonable alternatives.”* This added emphasis on the role of alternatives available to the different parties implies a greater need to focus on why it makes sense for the various affiliates that source products from the sourcing company to accept whatever pricing arrangements are in place.
- *Impact of transition.* Introducing a sourcing company into the supply chain, or significantly changing the functions of an existing sourcing company typically involves a shift in assets, functions and/or risks. The new OECD Guidelines require taxpayers to evaluate whether, at arm’s length, this transition would entail an exit payment or whether the pre-existing pricing arrangements would affect the post-transition pricing arrangements.

Transfer Pricing Issues Raised by Centralized Purchasing

Centralized sourcing is often a business necessity for a modern MNE – raw materials and finished products are often sourced globally, requiring the MNE to evaluate sourcing alternatives in diverse parts of the world and understand how to deal with local vendors who, for example, follow different business practices or speak a different language. Centralized purchasing companies are entitled to realize an arm’s-length amount in return for the purchasing functions performed. As a result, centralizing the purchasing function often provides an opportunity to link business objectives with tax planning.

At one extreme, a centralized sourcing company may function in a purely transactional role, in effect stepping into pre-existing supplier relationships and contractual arrangements. In this case, the central purchasing entity processes transactions according to

Centralized purchasing companies are entitled to realize an arm’s-length amount in return for the purchasing functions performed. As a result, centralizing the purchasing function often provides an opportunity to link business objectives with tax planning.

pre-established contracts and places orders with contracted sellers only. The company often does not assume any risks in relation to the transactions. For transfer pricing purposes, it may be difficult to argue that any excess profits from the trading activity should be allocated to the central purchasing entity.

However, to the extent that the centralized sourcing company significantly contributes to the supply chain, it may be able to capture at least a share of the incremental profits realized from such procurement activities. At a high level, such strategic contributions can be done by either:

- *Performing functions that are critical to the supply chain and can only be accomplished effectively by a centralized/regional sourcing company.* Such functions typically include:
 - functions related to centralization and consolidation, such as centralizing risks, consolidating purchase orders to realize

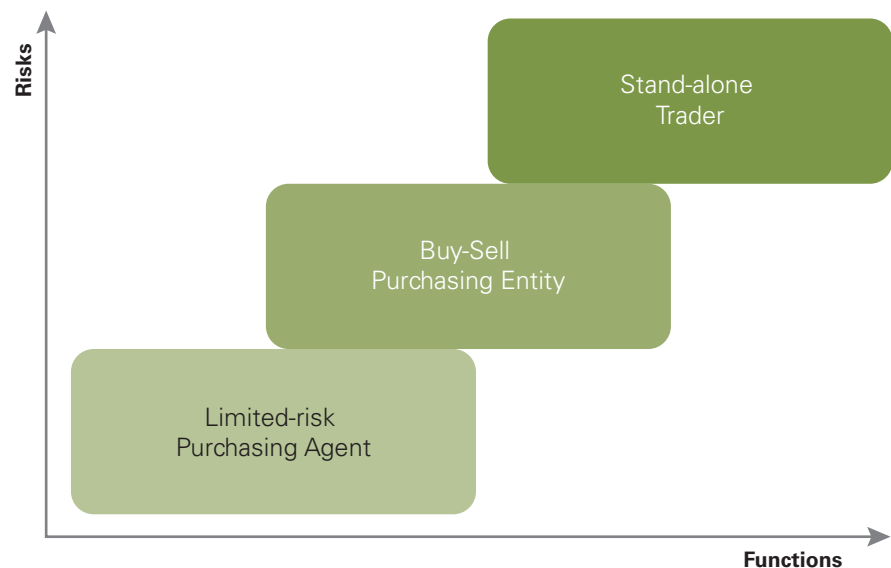
purchasing power, and evaluating and managing vendors in different regions and countries

- local vendor management activities that are difficult to place in the parent company, such as factory inspections for quality control and knowledge of local language and business practices.

- *Assuming key risks, such as exchange rate risks, risks of price fluctuations and contractual volume commitments.* The more risks the central purchasing entity assumes, the higher the *expected* compensation should be; the entity's transfer prices should allow for such higher anticipated profits. This assumption of risk must be real and established up front, which implies the possibility that actual financial results may differ markedly from expected results.

Figure 2 highlights the relationship between risk-bearing, functions and expected profits in a sourcing company.

Figure 2



Source: KPMG International 2011

Centralized purchasing entities that make strategic contributions to the supply chain often focus on transfer pricing approaches that are driven by their total revenues/total costs rather than by specific operating

expenses related to their activities. In developing such an approach, MNEs often look to the comparable uncontrolled price method and rely on the gross markups/commissions realized by third-party

procurement companies. This pricing is often expressed as a percentage of the total purchases made by (or arranged by) the sourcing company, and often leads to substantially different financial results than an alternative pricing method that reflects a markup on operating expenses alone.

For example, a sourcing company may have 1 in operating expenses relating to its employees, facilities, etc., while purchasing 100 percent of product on behalf of or for the benefit of its affiliates. Data from third-party sourcing companies may suggest that the arm's-length payment should be equal to 5 percent of the value of purchased materials, or 5, implying a 500-percent markup on its operating expenses. This markup is substantially greater than the profits that would be supported by a transfer pricing analysis that used a TNMM approach, which would probably suggest an arm's-length markup on operating expenses of 5–20 percent of such costs, or 0.05 to 0.20 (rather than 5.0).

The key question is how a taxpayer can justify the use of the gross markups on the cost of product purchases implied by the third-party comparables when such markups imply a profit that is substantial in relation to operating expenses. In the past, taxpayers have often relied on the OECD Guidelines' clear preference for the CUP method and its relegation of the TNMM to the method of last resort.

Tax authorities have challenged this view in the past, however. In the Netherlands, the tax authorities successfully overturned the pricing established by taxpayers in two court cases.¹⁷ The first case, decided in 2003, dealt with a Dutch subsidiary that was part of Group A. Until 1992, the subsidiaries of Group A purchased their own materials (mainly tin and aluminum). In 1993, the Group established a purchasing center in Belgium that centrally negotiated purchasing contracts on behalf of and in the name of the Group's subsidiaries. A portion of the discount resulting from the greater purchasing power was directly paid by independent suppliers to the central purchasing entity. The compensation earned by the Belgian purchasing center exceeded its operating expenses by more than 600 percent.

The Dutch Court concluded that this compensation was excessive, and that instead the compensation of the sourcing company should be limited to a 5-percent markup on its operating expenses (excluding the value of the procured materials). In reaching this decision, the Dutch Tax Court considered the following factors:

- *Functions.* The activities of the Belgian central purchasing entity were limited to negotiating prices. The negotiations took place in the name of the subsidiaries, which still concluded and signed contracts and continued performing other purchasing activities.
- *Risks.* The Belgian purchasing entity assumed risks with respect to its operating expenses only. The agreement between the subsidiaries and the central purchasing center did not refer to any amounts or method of remuneration. The coordination fee was fixed at 1.25 percent of the gross purchase price and did not depend on the success of the entity's negotiations. The entity's profitability arose from a favorable pricing regime rather than its own efforts, and it could only stem from the shareholder relationship.

In 2006, the Dutch Tax Court also decided in favor of the Dutch Tax authority in another central purchasing case. In this case, the tax inspector first asserted that the Hong Kong purchasing company was effectively based, or had a permanent establishment, in the Netherlands and attempted to impose Dutch corporate income tax assessments on the activities in Hong Kong. The tax inspector later changed its approach and asserted that the transfer prices applied between the Dutch group company and the Hong Kong purchasing entity were not arm's length.

The Hong Kong purchasing company had an office, showroom and five employees. The company's core activities consisted of quality control of products manufactured by independent suppliers in China, logistics (loading and shipping), order tracing, product development and purchasing, and sales including trade fair visits. The Hong Kong purchasing company added a 10-percent markup to the prices that it paid independent

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¹⁷ Because of the new OECD Guidelines on business restructuring the presented view of the Dutch tax authorities may not necessarily represent the current view of the Dutch tax authorities.

Chinese suppliers based on the markups realized by comparable sourcing companies.

The Dutch Tax Court rejected these comparables and concluded that a 10-percent markup on the operating expenses of the Hong Kong purchasing entity was more appropriate. In essence, the taxpayer failed to convince the Dutch Tax Court that the showroom and five employees of the Hong Kong sourcing company justified the 10-percent markup on the cost of purchased products.

US taxpayers using comparable uncontrolled prices to support the payments made to sourcing companies have often been more successful in withstanding challenges from the IRS. In doing so, however, taxpayers have been forced to provide significant documentation to support the specific functions carried out by the sourcing companies and especially their role in coordinating purchases from and overseeing a wide range of third-party suppliers.

The principles set forth in the recently released OECD Guidelines also strongly suggest that taxpayers will have to provide substantial support for the use of comparable uncontrolled prices that lead to a steep markup on operating expenses. Taxpayers can be expected to have to document the following items.

- The sourcing company, to the extent it bears risks, has in place and adheres to an arm's-length contract that allocates such risks beforehand.
- The sourcing company has the substance, in terms of people, capabilities and financial capacity, to be responsible for the risks assumed and the functions that are carried out. While this does not require the day-to-day management of the risk, the sourcing company is generally expected to make relevant decisions to control its risk, including:

- taking responsibility for the decision to hire or terminate the entity that is managing risk on a daily basis on its behalf
- determining the type of work that is being done
- making key spending decisions
- assessing the outcome of the work done.

- The pricing used takes into account the reasonable alternatives available to the different legal entities. For example, the taxpayer is likely to be asked whether the sourcing company provided a benefit that was commensurate with the price charged; otherwise there would be no reason to buy from the sourcing company. In the example above, this suggests that the taxpayer should be able to demonstrate cost savings/revenue enhancements of at least 5 percent of the value of purchased product.

To the extent that existing functions are moved from other related parties to the sourcing company, the taxpayer will likely have to document whether any payment would be expected at arm's length for this transfer of functions, either as a formal exit charge or as an adjustment to the pricing derived from the comparable transactions.

Conclusion

European and American MNEs increasingly source from Asian suppliers and establish centralized purchasing functions in Asia to achieve business objectives. Depending on the purchasing centralization strategy, these restructurings could shift profits away from the US and European taxpayers, and American and European tax authorities may have concerns over the resulting lost tax revenue. To defend a restructuring, MNEs must be able to explain the business rationale in timely proposed documentation and prove that transfer prices for transactions with the centralized purchasing entity meet the arm's-length standard.

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Contributor:

Jeroen Dijkman
KPMG in the Netherlands
Email: dijkman.jeroen@kpmg.nl



Location Savings

Measuring location savings by simply comparing individual input prices (e.g. labor costs) may overstate such benefits. There are often location “dis-savings” related to items such as higher transportation costs and the need for increased inventory.

A multinational group can derive location savings by relocating certain activities to a country where costs, such as labor and real estate, are lower. Issues related to location savings often come up in Asia, as labor and materials prices are often lower in many Asian countries than they are in the US and Europe. Indeed, such savings are often a primary reason for moving manufacturing from the US and Europe to Asia. Under such circumstances, local tax authorities are often likely to view location savings as a local attribute that should be captured by the local legal entity; however, the tax authority of the entity that is sourcing the product is likely to view the low-cost manufacturer as a “contract” manufacturer that should be rewarded with a modest cost plus.

Per Chapter IX, paragraph 9.149 of the Organisation for Economic Co-operation and Development (OECD) Guidelines, location savings should be allocated to each party based on what independent parties would have agreed to in similar circumstances. The OECD Guidelines state that when determining and measuring location savings, it should be considered whether the multinational was able to capture the location saving benefits in higher profits or whether the benefits were passed on to the consumer in the form of lower prices. Certain items, such as higher transportation costs or the cost of training local employees, may offset the benefits from location savings.

The treatment of location savings is complex and often controversial. In evaluating this issue, it is important to consider the following questions.

Do location savings actually exist, and, if so, how large are they?

Measuring location savings by simply comparing individual input prices (e.g. labor costs) may overstate such benefits. There are often location “dis-savings” related to items such as higher transportation costs and the need for increased inventory. (In Paragraph 1.48, the OECD Guidelines also include termination costs as a dis-saving. Whether such a cost would affect the analysis depends on whether a payment for such termination costs would be needed at arm’s length.) Further, companies adjust their use of resources based on input prices; production in a high labor cost area is likely to substitute capital for labor and therefore mitigate the impact of wage rate differences.

Was the multinational enterprise (MNE) actually able to capture the benefits of such location savings, or are they passed on to the customers of the MNE through lower prices?

The answer to this question may vary over time: “first movers” may realize higher profits by moving to a low-cost location, but competition may diminish such profits over time. Manufacturers can generally realize higher profits when their costs are lower than those of other manufacturers in the industry, such as companies that make initial investments in countries with low labor costs. However, once all manufacturers start to operate out of countries with low wage costs, normal assumptions about competitive behavior suggest that these cost savings are likely to be passed on to customers. Therefore,

the location of competitive manufacturing facilities can be a key factor in reviewing this issue.

Which legal entity would capture such location savings at arm's length?

This complex economic issue depends on the alternatives available to the different participants involved in the transaction. One approach to this issue is to evaluate whether there is worldwide pricing and/or whether the pricing is set in the buyer's market, allowing the seller to possibly capture location savings, or whether the buyer could select among multiple alternative suppliers in the seller's market. In the United States, Revenue Procedure 63-10 discusses some of the economic issues involved.¹⁸ In this regard, there are a number of cases in which arm's-length prices vary depending on the source of supply, with one price being paid for products made in markets close to the customers (generally, the US or Europe) and a lower price paid for products produced in lower-cost but more distant markets. This differential typically reflects implicit values that the buyer places on location, such as faster delivery times, a greater ability to monitor production for more advanced products, and perceived differences in quality or reliability of supply. In some cases (e.g. automotive industry, call centers), buyers may contract

for some of their needs from low-cost, low-price sources of supply and from high-cost, high-price sources for the rest of their needs.

The issue of location savings is simply a special case of the issue of how the cost advantages of specific market participants are treated. It is relatively common for different producers to have different costs, with cost-effective producers realizing higher-than-average profits and with producers with higher costs realizing lower profits – or even losses if they cannot exit the market without significant costs.

In recent discussions on transfer pricing issues in the automotive industry, the State Administration of Taxation (SAT) acknowledged the various points raised above but also expressed the view that location savings are an attribute of the local Chinese market and thus reside with the local Chinese entity (See "Insights from SAT Training on Automotive Issues" on page 33). The SAT believes that Chinese entities have been under-remunerated for several years and argue that some, if not all, of the location savings should be recognized in China. Similarly, Indian tax authorities often cite the existence of location savings to support high markups in their transfer pricing adjustments.

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Contributors:

Cheng Chi
KPMG in China
Email: cheng.chi@kpmg.com

Jerry Klopfer
KPMG in the United States
Email: jklopfer@kpmg.com

¹⁸ The IRS has revoked this revenue procedure.


Section

3

Options for Resolving Controversy



Overview



The combination of increasingly complex supply chains and a sharper focus on transfer pricing on the part of tax authorities has led to a predictable increase in transfer pricing controversy. Many companies have now shifted IT development and back office services to low-cost locations, especially India. In the past, the transfer pricing of such services was not likely to cause significant exposures – a cost plus markup of 5–10 percent provided a conventional and safe policy. In recent years, however, the Indian tax authorities have audited companies aggressively and insisted on much higher markups. Resolving transfer pricing disputes in India can be expensive and time-consuming.

In many countries, however, the number of procedural options for resolving transfer pricing disputes is rising. The advance pricing agreement (APA) reports issued by Australia, China, Japan, and Korea all suggest vibrant and growing APA programs. Accelerated competent authority procedures in the United States and Canada (and some other countries) are bringing more years into a single competent authority negotiation, which also can have the effect of resolving more

The combination of increasingly complex supply chains and a sharper focus on transfer pricing on the part of tax authorities has led to a predictable increase in transfer pricing controversy.

recent years. Finally, mandatory arbitration provisions are being incorporated into a greater number of treaties, including those of the United States, Canada and the EU generally.

In some cases, litigation appears to be the only answer, and we have recently seen two cases – *GE Capital* in Canada and *Veritas Software* in the United States – where court decisions have been needed to resolve difficult transfer pricing issues.

While most of the discussion of supply chain issues focuses on tangible and intangible property transactions, the outsourcing of IT, headquarters activities, and other services has become important in recent years. This outsourcing creates transfer pricing issues, and, to the extent that the activities are outsourced to India, taxpayers may be forced to deal with one of the world's most aggressive tax authorities. Some key facts in this regard are as follows.

- Indian transfer pricing rules require the Indian Internal Revenue Service (IRS) to conduct a transfer pricing audit of any taxpayer with intercompany transactions in excess of INR 150 million (approximately USD 3.3 million).
- A large proportion of transfer pricing audits in India result in transfer pricing adjustments. According to recent estimates, more than half of the cases selected for scrutiny undergo transfer pricing adjustments. Many of these adjustments are based on cost plus markups that many taxpayers and other tax authorities believe are well above the normal markups expected in other countries.
- While there is an appeals process that taxpayers can use to protest adjustments made at the examination level, the process is generally time-consuming. The Dispute Resolution Panel (DRP) route, introduced to fast-track the appeals process, has not lived up to expectations; in its first year of operation, the DRP generally re-affirmed the decision of the examination officer. On the other hand, the regular route of appealing to the Commissioner (Appeals) has given relief to taxpayers in some cases. However, as there is no time limit for the Commissioner (Appeals) to dispose of cases, this route entails a longer time period.
- Many taxpayers are forced to initiate litigation at the second appellate level, the Indian Income-Tax Appellate Tribunal, to seek relief from the initial adjustment. A large number

of cases have been filed with the Tribunal, and more than 40 Tribunal decisions were issued in 2010 alone.

- In principle, competent authority relief is available for transfer pricing issues that involve countries with which India has a tax treaty, and the Indian and US competent authorities have recently settled a number of cases. However, the settlements have reflected relatively high cost plus markups – in the upper teens for the initial round of settlements and over 20 percent in the more recent ones – which may reinforce the views of Indian local auditors that such high cost plus markups are appropriate. Note that when a mutual agreement procedure (MAP) is initiated between India and the United States in respect of transfer pricing adjustments, it is possible to obtain a stay of tax demand while the MAP is pending, subject to certain formalities such as the furnishing of a bank guarantee. Similar relief is possible in the case of MAPs for transfer pricing disputes involving the UK and Denmark as well.

Whether the process of dealing with transfer pricing issues in India will become easier, more predictable, and more rapid in the future remains to be seen. As noted, India passed legislation in 2009 that was designed to improve the process of resolving transfer pricing disputes in India. One key element of this legislation included the introduction of a special DRP to accelerate the appeals and resolution of transfer pricing cases. Key features of the alternate dispute resolution system are as follows.

- Taxpayers who are subject to a transfer pricing adjustment made by the Indian transfer pricing officer are eligible to present their case before the DRP. The DRP is set up by the Central Board of Direct Taxes and comprises of three Commissioners of Income Tax.
- Under the DRP mechanism, when a transfer pricing officer redetermines the arm's-length price of a taxpayer's international transactions, an order is issued by the transfer pricing officer

proposing an adjustment; the order is then forwarded to the assessing officer, who prepares a draft assessment order.

- The taxpayer gets 30 days to either accept the draft order or lodge objections before the DRP. The DRP considers the facts of the case, the objections raised by the taxpayer, and other relevant information. The DRP then issues to the tax officer a directive that contains the decision of the DRP and instructions to the assessing officer to conclude the final assessment. During this period, the taxpayer and/or the assessing officer are afforded an opportunity for a hearing.
- The directive of the DRP is binding on the tax officer and has to be passed within a maximum time frame of nine months from the end of the month in which the draft order is made available to the taxpayer.
- If the taxpayer were to disagree with the final assessment order, the next step would be for the taxpayer to initiate an action before a tax tribunal. (This process is in contrast with the current procedure, wherein the taxpayer can approach the Appellate Commissioner (for seeking relief) before taking the matter to a tax tribunal.)

One advantage of the DRP mechanism is the possibility of early resolution or at least a hearing at a level above the tax or transfer pricing officer. A second advantage is that, because no final assessment order can be issued until the DRP disposes of the case, the amount of the tax demand would automatically be held in abeyance.

While DRP is a welcome development in principle, how effective it will be in practice remains in question. The results of the DRP's first year of operation are not promising, with a large number of cases being decided in favor of the Revenue,

often with no independent consideration of the merits of the case. During the first year, the DRP process was overwhelmed by an excessive number of cases and an inadequate number of qualified members, who functioned as DRP members in addition to carrying out their usual duties. This may have contributed to their apparent willingness to re-affirm the initial transfer pricing assessment. The functioning of the DRP has come under criticism from the judiciary, as can be seen from some recent rulings of Tribunals as well as High Courts. These rulings have described some DRP orders as "laconic" and "non-speaking" and held that it is incumbent upon a quasi-judicial authority like the DRP to pass reasoned orders. Whether the DRP will function any differently in the second year and offer an advantage over the traditional appeals process remains to be seen.

India also plans to introduce an advance pricing agreement (APA) process, although the option will not be available until April 1, 2012 and it will be prospective. This is a promising development: the APA program offers hope that taxpayers can reach a prospective agreement that covers a number of years. However, the key question is whether it will be implemented effectively. One apparent limitation of the program is that it likely will be limited to unilateral APAs and will therefore not bring in other tax authorities as counterparties to balance the positions of the Indian APA office. Given the recent experience with the DRP, this may be of particular concern in India, as there is an open question as to whether the APA office will simply re-affirm the views of the typical transfer pricing officer and thus require the same markups. If so, taxpayers could be significantly exposed to audit adjustments from the tax authorities of the counterparties to the transaction and left with litigation as the only way of moderating the Indian tax officers' positions.

The results of the DRP's first year of operation are not promising, with a large number of cases being decided in favor of the Revenue, often with no independent consideration of the merits of the case.

Contributors:

Steven D. Harris
KPMG in the United States
Email: sdharris@kpmg.com

Rohan Phatarphekar
KPMG in India
Email: rohankp@kpmg.com

Asian APA Statistics

Overview

Many countries in Asia provide taxpayers with the opportunity to use advance pricing agreements (APA) to achieve greater certainty regarding their transfer pricing. Four of these countries – Australia, China, Japan and Korea – have issued reports providing details of their APA experience, with the level of detail varying by country. The discussion below summarizes key facts from these various APA reports.

Australia: Summary of the State Taxation Office's APA Annual Report

China: Summary of the State Administration of Taxation's APA Annual Report

Japan: APA Program Report

Korea: Summary of the National Tax Service's APA Report



Australia – State Taxation Office’s APA Annual Report

The Australian Taxation Office (ATO) released its annual overview of its advance pricing agreement (APA) program for the financial year ended June 30, 2010 (FY10). The ATO completed 39 APAs in FY10, including 21 renewals, 12 new APAs encouraged by compliance activity, and six new, unprompted APAs. Eighteen APAs were for large businesses (with revenues more than AUD 250 million), and 21 APAs were for small-to-medium enterprises (SME).

Processing time

According to the APA annual program report, the ATO aims to complete an APA within 12 months after the application is filed. The time required to complete the APA depends on various factors such as the availability of information; the amount of cooperation between the ATO, the foreign tax authority and the taxpayer; and the resources available to undertake the process.

APAs in FY09-FY10 took an average of 12 months to complete with 64 percent of APAs completed in 12 months or less and 13 percent taking 36 months or more.

The average time to complete a unilateral APA in FY10 was five months (compared to 10 months in FY09), and the average time to complete a bilateral APA was 25 months (compared to 12 months in FY09).

Covered transactions

In FY10, ATO completed bilateral APAs with Korea, Japan, New Zealand, Switzerland, the United States and Singapore. As of June 30, 2010, the ATO had 17 applications in the “pre-lodgment” stage and 60 applications in the “lodged and in-progress” stage.

The report describes the different types of transactions covered by the APA program, including tangible goods, business and management services, information technology software and hardware, mineral exports, licensing of marketing intangibles, financial services, and contract research and development. Table 4 summarizes the APAs completed in FY10 by type. Several APAs covered more than one type of transaction; the primary dealing is listed in the middle column and all dealings are listed in the right-hand column.

Table 4

Type of Dealing	Primary Dealings	All Dealings
Tangible property	26	26
Intangible property	3	3
Services	10	19
Total Completed	39	

Source: Australian Tax Office annual program report

Methodology

Among the transfer pricing methodologies applied, the Transactional Net Margin Method (TNMM) was most commonly used in FY10. The report explains that the TNMM is used most often since taxpayers have access to independent comparable data for various countries.

The ATO completed more APAs in FY10 related to the acquisition or supply of services and typically applied the cost plus method for these transactions.

By periodically disclosing APA program developments, the SAT aims to enhance cooperation from taxpayers, provide more transparency with respect to China's transfer pricing regulations, and set out guidelines for their application.

China – State Administration of Taxation's APA Annual Report

In December 2010, China's State Administration of Taxation (SAT) issued its inaugural APA report, which introduces the program, implementation procedures, and related forms. The report also discusses recent developments in APA practice in China, as supported by a statistical survey of China's APA program for the period from January 1, 2005 to December 31, 2009.

Overview

In issuing this document – known in English as "China Advance Pricing Arrangement Annual Report" – China joins other national

tax authorities (including the United States, Japan, Korea, Australia, Canada and Italy) in publishing a comprehensive report on its APA program. By periodically disclosing APA program developments, the SAT aims to enhance cooperation from taxpayers, provide more transparency with respect to China's transfer pricing regulations, and set out guidelines for their application. The APA report underscores the SAT's interest in further developing and enhancing its APA program.

China's tax authorities signed 53 APAs during the five-year period between January 1, 2005 and December 31, 2009,



of which 41 agreements were unilateral APAs and the remaining 12 agreements were bilateral APAs. Interestingly, the statistics reveal an increasing trend toward bilateral APAs being successfully negotiated, while the number of successful unilateral APAs each year is decreasing. In 2009, seven bilateral APAs were signed while only five unilateral APAs were signed.

China's APA procedures

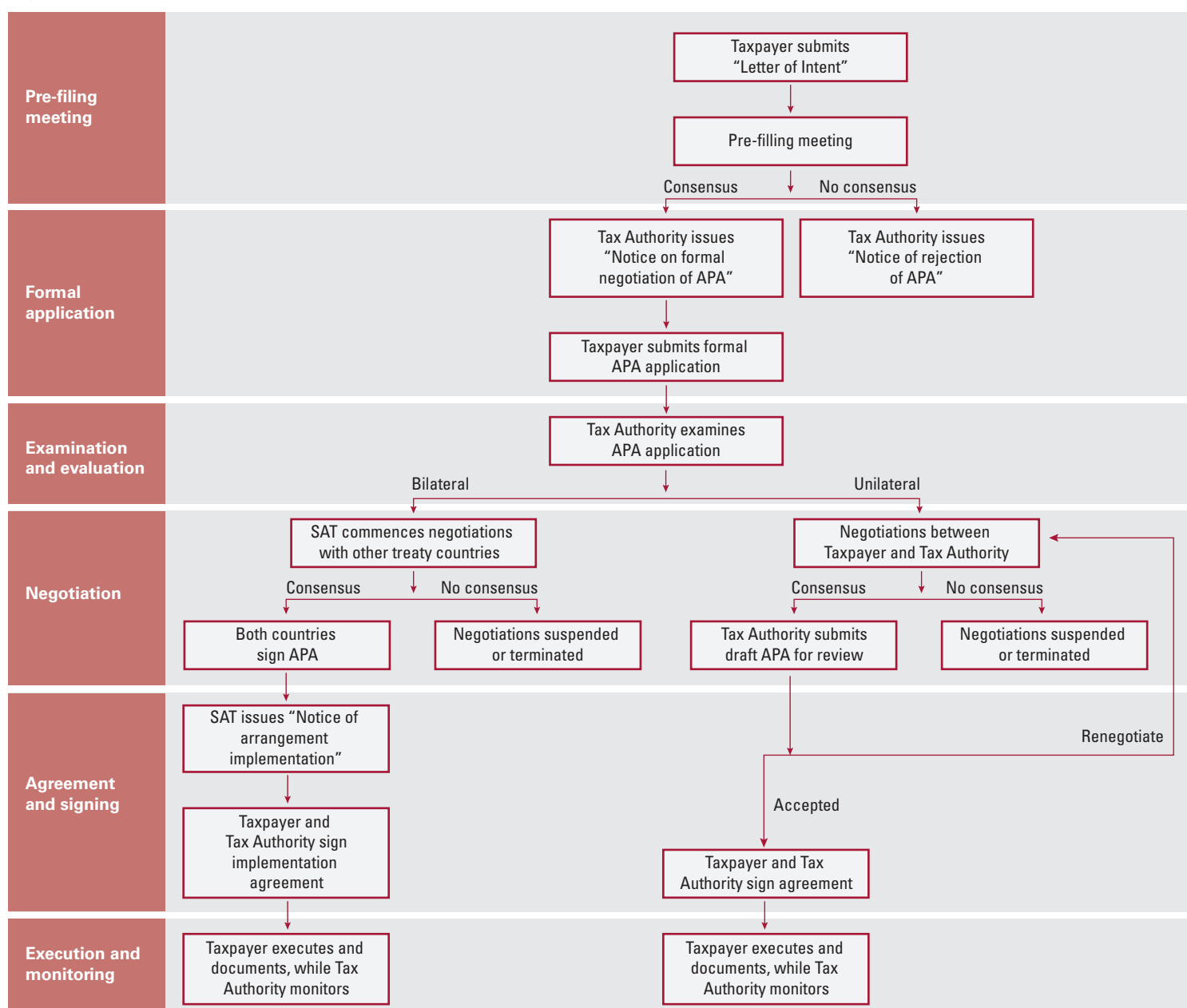
China's program is jointly administered by local tax authorities and the SAT for unilateral APAs and by the SAT alone for

bilateral APAs. China's transfer pricing regime also sanctions multilateral APAs. To apply for an APA, taxpayers generally must have annual related-party transactions exceeding RMB 40 million (approximately USD 6 million).

APAs are valid for transactions conducted in a period of three to five consecutive years, starting from the year after the year in which a formal written application is submitted. No application fee is required.

As the flow chart in Figure 3 shows, the APA process generally involves six steps.

Figure 3



Source: KPMG in China: Summary of the State Administration of Taxation's APA Annual Report (December 2010)

The total processing time is on the rise. One possible reason is that the SAT increasingly tends to examine the submitted information more carefully and perform more technical analysis and industry research.

Rollback

The terms and conditions agreed on in an APA have effect from the year after the year in which the formal written application is submitted. Therefore, any agreement on pricing made within an APA is not legally binding for any tax audits in the year during which the enterprise submits its formal written application or for any prior year. However, APAs can be retroactively applied to identical or similar transactions covered in the APA on request and with the tax authorities' approval. The relevant regulations for transfer pricing investigations are applicable to a rollback period of up to 10 years.

Acceptances, processing time, and conclusions

According to the APA report, the tax authorities had been involved with 120 APAs at various stages as of December 31, 2009:

- The number of cases pending in the pre-acceptance phase had risen to 51 applications; 20 of these cases were at the informal discussion stage.
- From 2005 through December 31, 2009, there were 54 agreed APAs: 24 expired APAs, 29 executed and monitored and one which has been agreed but not yet signed. As of December 31, 2009, there were 15 APA applications in the acceptance phase where an APA has been accepted by the tax authority, but an agreement has not been reached.
- Of the 53 concluded APAs, 41 were on a unilateral basis and 12 on a bilateral basis.
- The bilateral APAs included nine APAs negotiated with other Asian countries, two APAs negotiated with European countries, and one APA negotiated with the United States.

The report states that, of the 53 APAs signed during the five-year period from 2005 through 2009, only two APAs (both bilateral) took longer than two years to be processed.

For both unilateral and bilateral APA applications, more than half were processed within one year. The time required depends on many factors such as the type of APA, the complexity of the issues involved, the quality of the

information provided, the extent of cooperation, and the workload of the tax officers.

The total processing time is on the rise. One possible reason is that the SAT increasingly tends to examine the submitted information more carefully and perform more technical analysis and industry research. The SAT now spends time on its own functional analysis during the examination and evaluation phase to verify the facts set out in the APA application report. The SAT sometimes even visits industry associations to obtain more industry-specific insights.

Transaction types

The report describes the different types of transactions covered by the APA cases during the five-year period. The largest category of transactions covered was the "purchase and sale of tangible assets", which appeared in 42 completed APAs and in 11 APAs that were at the formal acceptance stage. The second largest category was the "transfer of intangible assets", which appeared in 13 concluded APAs and eight APAs at the formal acceptance stage, followed closely by the "provision of services" covered in 13 concluded APAs and five APAs in the formal application stage.

The report states that the SAT expects the share of tangible asset transactions to decrease relative to other transaction types, in light of China's tertiary industry development.

Transfer pricing methods

The APA report states that the most common transfer pricing method applied in both unilateral and bilateral APAs was the transactional net margin method, which was used in approximately 60 percent of signed APAs (Return on sales and full cost markup were the most commonly used PLIs).

The second most common transfer pricing method was the cost plus method, which was applied 15 times. The comparable uncontrolled price (CUP) method was applied four times and the profit split method was applied twice, while the remaining two methods applied were defined as "Other."

The report anticipates that the resale price method and the profit split method will be applied more frequently in the APA program the future.

The TNMM still dominates the APA landscape, especially for limited function entities such as contract manufacturers and as a method to determine the routine profit when a residual profit split method is used. However, the SAT has expressed its intention to apply other methods. It has been observed that the SAT intends to use the profit split method in the future. The SAT believes that local entities have contributed to the development of part of the local intangibles (such as local marketing and the development of local customer relationships) and that

the profitability of the Chinese entities should reflect this contribution. There is an indication that the tax authorities would move toward an approach that combines primary and collaborative methods.

Tax professionals in China anticipate that the SAT will increase its emphasis on taxpayers providing information during the APA negotiation process because the tax authorities believe this will enable them to apply methods other than TNMM. This may become one of the SAT's key criteria for accepting an APA application.

Japan – National Tax Agency's APA Program Report

The National Tax Agency (NTA) initiated the advance pricing agreement (APA) program in 1987, making Japan the first country to implement such a procedure. During its 2009 business year (July 1, 2009 to June 30, 2010), the NTA received 149 bilateral

APA requests, completed 105 bilateral APAs, and carried over 305 bilateral APAs to the following year. Table 5 compares these results to the NTA's 2007 and 2008 business years.

Table 5: Japan – Summary of Bilateral APA Statistics

Year	Cases Received	Cases Completed	Cases Carried Over
2007	113	82	222
2008	130	91	261
2009	149	105	305

Source: NTA APA Program Report 2010

The NTA is currently promoting bilateral APAs to facilitate the enforcement of transfer pricing regulations and to ensure tax predictability for taxpayers. The annual report indicates that the number of APA renewals has risen in recent years. In addition, the geographical area covered by APAs is expanding as new countries have become involved in the bilateral APA process with Japan.

Processing time

The time required to complete a bilateral APA varies depending on the nature of each case; however, the average time to complete a bilateral APA in 2009 was 24.7 months.

Covered transactions

In 2009, the NTA completed bilateral APAs with 18 countries, including:

Switzerland	Ireland	United Kingdom
Spain	Italy	Germany
Belgium	Netherlands	Luxembourg
France	Sweden	Canada
United States	Australia	China
Thailand	Singapore	Korea

Source: NTA APA Program Report 2010

The NTA received the largest number of bilateral APA cases in 2009 from the United States, Australia, and the United Kingdom.

Korea – National Tax Service's APA Annual Report

Korea's advance pricing agreement (APA) regime was enacted in 1995 and introduced into Korean tax law in 1997. In August 2010, the National Tax Service (NTS) released its third APA report with information related to the 2009 APA program. Since the program's inception, the NTS has received 212 APA requests and concluded 133 cases as of December 2009.

APA applications filed and administrative status

Table 6 shows the cumulative number of APA applications filed since the introduction of the APA program in 1997 and their administrative status as of December 2009. More applications were filed for bilateral APAs than for unilateral APAs.

Table 6

	Applications filed	APAs approved	APAs being processed
Bilateral APAs	116	63	53
Unilateral APAs	96	70	26

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

Table 7 shows the number of bilateral and unilateral APA applications filed each year.

Table 7

	Before 2002	2003	2004	2005	2006	2007	2008	2009	Total
Bilateral	24	4	10	10	12	13	22	21	116
Unilateral	9	3	6	15	12	19	13	19	96
Total	33	7	16	25	24	32	35	40	212

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

Table 8 provides a list of countries and the respective number of APA applications filed and processed as of

December 2009. The country with the most applications is the United States, followed by Japan and Switzerland.

Table 8

	Bilateral APAs	Unilateral APAs	Total
United States	32	17	49
Japan	15	16	31
Switzerland	4	6	10
Hong Kong	0	8	8
China	5	2	7
United Kingdom	3	4	7
Singapore	0	7	7
Sweden	0	3	3
Australia	3	0	3
Others	1	7	8
Total	63	70	133

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

For the years 1997 through 2009, the average time to process and complete an APA application was 29 months for a bilateral APA and 20 months for a unilateral

APA. Table 9 presents the number of completed bilateral and unilateral APAs and the time required to complete the process.

Table 9

	Average time required for the years 1997 – 2009	Number of completed APAs/time required			
		< 2 years	2 – 3 years	> 3 years	Total
Bilateral	29 months	31	17	15	63
Unilateral	20 months	70	0	0	70
Total		101	17	15	133

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

For APAs approved during 2009, it generally took 14 months to close a bilateral APA, which is 15 months shorter than the average time presented above. Further, the average time to conclude a unilateral APA in 2009 was 18 months. Therefore, bilateral and unilateral APAs took less time to complete on average in 2009.

Covered transactions

Among the 27 APAs approved in 2009:

- Twenty-one APAs involved tangible asset transactions (including purchases of raw materials, semi-finished goods, and finished goods)
- Three APAs involved intangible asset transactions (including royalties for the use of technology and trademark and license fees)

- Three APAs involved service transactions (including sales support and brokering services).

An analysis of these figures indicates that 78 percent of approved APAs in 2009 involved tangible asset transactions, 11 percent involved intangible asset transactions, and 11 percent involved service transactions.

APA term

As Table 10 shows, of the 27 APAs approved in 2009, most taxpayers selected a five-year period to be covered by the APA.

Table 10

	APA Terms				
	2 years	3 years	4 years	5 years	Total
Bilateral	0	0	3	4	7
Unilateral	1	3	0	16	20
Total	1	3	3	20	27

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

Thirteen of the 27 APAs concluded in 2009 included a rollback. Of these APAs, the rollback period for four APAs was one year, and the period was three years for eight APAs. One APA had five-year rollback period.

Methodology

Among the transfer pricing methodologies applied in the 27 APAs approved in 2009, the transactional net margin method was selected the most and the operating margin was the most commonly used profit level indicator. Table 11 presents the methods and profit level indicators selected for the APAs completed in 2009.

Table 11

	Bilateral	Unilateral	Total
Comparable Uncontrolled Price Method (CUP)	0	0	0
Resale Price Method	0	0	0
Cost Plus Method	0	0	0
Profit Split Method	0	0	0
Other Reasonable Methods	0	1	1
Transactional Net Margin Method	7	19	26
<i>Operating Margin</i>	<i>1</i>	<i>12</i>	<i>13</i>
<i>Full cost Markup</i>	<i>3</i>	<i>3</i>	<i>6</i>
<i>Value-added Cost Markup</i>			
<i>Return on Asset</i>			
<i>Berry Ratio</i>	<i>3</i>	<i>4</i>	<i>7</i>
Total	7	20	27

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

Industry Analysis

The APAs approved in 2009 covered various industry sectors from the computer/cell phone industry to

the automobile/transportation equipment industry. Table 12 provides an overview of the APAs by industry in 2009.

Table 12

Industry	Bilateral	Unilateral	Total
Computer/LCD/Cell Phone	4	1	5
Automobile/Transportation Equipment	0	2	2
Chemistry/Pharmaceutical	0	8	8
Finance/Securities	0	0	0
Apparel	0	3	3
Food and Beverage	0	0	0
Publishing/Software	0	1	1
Machinery	2	2	4
Wholesale (General Trading)	1	2	3
Semiconductor	0	1	1
Other	0	0	0
Total	7	20	27

Source: KPMG Samjong Accounting Corp. and NTS 2009 APA Annual Report

Contributors:

Cheng Chi
KPMG in China
Email: cheng.chi@kpmg.com

Daisuke Horiguchi
KPMG in Japan
Email: daisuke.horiguchi@jp.kpmg.co

Sang Min Ahn
KPMG in Korea
Email: sangminahn@kr.kpmg.com

Anthony Seve
KPMG in Australia
Email: aseve@kpmg.com.au

Accelerated Competent Authority Procedures

Overview

The OECD's *Manual on Effective Mutual Agreement Procedures*, released in February 2007, defines the accelerated competent authority procedure (ACAP) as follows:

In addition to an ongoing request for competent authority assistance, a taxpayer may request assistance for subsequent filed, but yet to be audited, taxation years on the same issue. The inclusion of these subsequent ACAP years in the mutual agreement procedure (MAP) discussions not only prospectively resolves double taxation but also alleviates the burden of separate audit and MAP processes.

The main benefit of ACAP is that it allows both the tax authorities and taxpayers to make their relevant audits/examinations more current by resolving the same issue over a number of taxation years. This allows tax authorities to focus on more recent taxation years for subsequent audits/examinations. ACAP can also provide substantial costs savings for both taxpayers and tax administrations, by eliminating the need to engage in the full cycle of audit/examination, adjustment and MAP process for each of the taxation years covered by ACAP. The procedure also allows for a faster resolution of transfer pricing issues, as it accelerates the MAP process to years that are not yet under audit.

ACAP is therefore one of the most promising developments in the resolution of double taxation taking a more proactive approach to double taxation and allowing tax authorities and taxpayers to become more current in their review and resolution of transfer pricing files.

ACAP is relatively new. Currently only a few countries have formal ACAP programs (namely, the United States, Canada and the Netherlands). However, this initiative has received the OECD's approval and, as with the progress of advance pricing agreements (APA) throughout the world, OECD endorsement should encourage ACAP's adoption by all OECD members. Moreover, while the number of countries with formal advance pricing agreements (APA) programs is relatively small, it is important to keep in mind that ACAP is an extension of the MAP and not a separate mechanism for resolving double taxation. As such, even those jurisdictions that do not currently have an ACAP program may still be open to allowing taxpayers to request ACAP in a manner similar to that by which some countries without official APA programs do enter into APAs. APAs, like ACAP, are an extension of the MAP.

ACAP is one of the most promising developments in the resolution of double taxation.

United States – Accelerated Competent Authority Procedure

The United States introduced its accelerated competent authority procedure (ACAP) in 2002 in Revenue Procedure 2002-52, and later in Revenue Procedure 2006-54, which modified and superseded Revenue Procedure 2002-52. Under the procedures for requesting ACAP (set out in Section 7.06 of Revenue Procedure 2006-54), a taxpayer requesting competent authority assistance with respect to an issue raised by the Internal Revenue Service (IRS) also may request that the competent authorities attempt to resolve the issue for subsequent taxable periods for which returns have been filed, if the same issue continues in those periods. A competent authority agreement reached with respect to the years covered by the competent authority request will be applied to the subsequent years covered by ACAP.

Based on informal discussions with the US competent authority, a US taxpayer who has an issue raised by the Canada Revenue Agency also may request ACAP with respect to such issue. We understand that this point will be clarified when Rev. Proc. 2006-54 is updated.

On receiving an ACAP request, the US competent authority will contact the appropriate IRS field office to consult on whether the issue should be resolved for subsequent taxable periods. If the IRS field office consents, the US competent authority will address with the foreign competent authority the request for the subsequent taxable periods.

In this respect, the US ACAP process differs from the competent authority process where ACAP is not requested. In the latter case, the US competent authority does not contact the IRS field office for consent to proceed with a competent authority case.

Under ACAP, a taxpayer is required to furnish all relevant information and statements that may be requested by the US competent authority pursuant to Revenue Procedure 2006-54. In addition, if the case involves a Coordinated Industry Case (CIC) taxpayer, the taxpayer must

furnish all relevant information and statements requested by the IRS, as described in Revenue Procedure 94-67 (dealing with the Accelerated Issue Resolution (AIR) process). The AIR process may advance the resolution of issues arising from an audit of a CIC taxpayer from one or more tax periods to other tax periods. If the case involves a non-CIC taxpayer, the taxpayer must furnish all relevant information and statements that may be requested by the IRS field office.

A request for ACAP may be made at the time of filing a request for competent authority assistance or at any later time. Generally, ACAP must be requested before the mutual agreement procedure (MAP) in the case is concluded. Taxpayers are encouraged to request the procedure as early as practicable. In certain cases involving litigation, the application of ACAP may require the prior consent of the Associate Chief Counsel (International).

A request for the ACAP must contain a statement that the taxpayer agrees that:

- the inspection of books of account or records under ACAP will not preclude or impede (under section 7605(b) or any administrative provision adopted by the IRS) a later examination of a return or inspection of books of account or records for any taxable period covered in the accelerated competent authority assistance request
- the IRS need not comply with any applicable procedural restrictions (for example, providing notice under section 7605(b)) before beginning such examination or inspection.

According to the IRS, ACAP also is implicitly invoked when a taxpayer requests a rollback of its requested bilateral APA to already filed years. Thus, the provisions of section 7.06 of Revenue Procedure 2006-54 technically apply when a rollback is requested pursuant to Rev. Proc. 2006-9, which governs requests for APAs filed with the Office of Associate Chief Counsel (International), Advance Pricing Agreement Program.

Canada – Accelerated Competent Authority Procedure

In Canada, the accelerated competent authority procedure (ACAP) was introduced in 2005 at paragraphs 21 to 23 of Information Circular 71-17R5, followed on December 12, 2008 by the release of TPM-12, “Accelerated Competent Authority Procedure (ACAP).” Before this release, the Canada Revenue Agency (CRA) refused to entertain unaudited taxation years as part of ACAP. However, in TPM-12, the CRA reversed this position. This position is in line with the US ACAP guidelines, which served as the basis for the CRA’s ACAP program.

According to TPM-12, the CRA will accept an ACAP request where:

- an ACAP request is made at the same time as the related mutual agreement procedure (MAP) request
- the issues in the ACAP request are the same as those in the MAP request
- years after those included in the MAP request and for which the taxpayer has requested ACAP consideration have been filed and initially assessed
- after consultation between the appropriate tax services office and the Competent Authority Services Division, the CRA is satisfied that the facts and circumstances have remained unchanged between the MAP and ACAP taxation years
- the other competent authority agrees to include the ACAP period with the related MAP request
- there are no issues involving unusual situations or transactions that would render the application of an ACAP impractical.

Contributors:

Sean Foley
KPMG in the United States
Email: sffoley@kpmg.com

Kristine Schlaman
KPMG in the United States
Email: kschlaman@kpmg.com

Brian Trauman
KPMG in the United States
Email: btrauman@kpmg.com

Arbitration – US – Canadian Developments

Many countries have had arbitration clauses in some of their tax treaties for at least ten years as part of the mutual agreement procedure (MAP) provisions, but few, if any, such arbitration provisions were ever invoked.

In February 2007, the OECD released “Improving the Resolution of Tax Treaty Disputes,”¹⁹ announcing its intention to change its *Model Tax Convention on Income and on Capital* (“OECD Model Convention”) to include an arbitration clause. Under this clause, arbitration would be available where MAP cases remain unresolved after two years.

One of the treaties signed after the OECD published its document on arbitration is the 2007 Protocol to the *Convention Between Canada and The United States of America With Respect to Taxes on Income and on Capital*²⁰ (the “Convention”). The 2007 Protocol inserted an arbitration procedure at paragraph 6 of the MAP article (Article XXVI) of the Convention. Under this provision, arbitration would be available for competent authority cases that have gone on for two years or more from their “commencement date,” which is the earliest date upon which both competent authorities have the information they need to consider the MAP request.

Under the Convention, arbitration may be available where:

- tax returns were filed with at least one of the Contracting States
- the case involves one or more articles of the Convention that the competent authorities have agreed can be the subject of arbitration and is not a case that the competent authorities have determined as not suitable for arbitration before the day on which arbitration was to start

- the competent authorities agree the case is suitable for arbitration (which seems to leave competent authorities with residual discretion to not accept a case for arbitration, even if it meets all other requirements)
- all persons concerned with the arbitration have reached a non-disclosure agreement.

The 2007 Protocol’s measures in respect of the MAP, including arbitration, took effect on December 15, 2008, and so the first possible arbitration cases under the Protocol could only start after December 15, 2010. Thus, on December 15, 2010, taxpayers whose competent authority cases under the MAP between Canada and the United States had been in process for two years but remained unresolved could, if they agreed and if all other conditions were met, see their cases transformed into arbitration cases.

The actual workings of the arbitration were partially set out in the diplomatic note number JLAB-0111,²¹ also referred to as Annex A to the Convention, which was published at the same time as the 2007 Protocol. The Canada Revenue Agency (CRA) and Internal Revenue Service (IRS) then released further details on the procedure in the form of a memorandum of understanding (MOU) and a set of operating guidelines. These documents offer the first comprehensive guidance to taxpayers on how the procedure will be implemented. Highlights of this guidance are found in the following paragraphs.

¹⁹ Available at <http://www.oecd.org/dataoecd/17/59/38055311.pdf>

²⁰ S.C. 1984, c. 20, as amended.

²¹ Available at http://www.fin.gc.ca/treaties-conventions/US_AnnexA-eng.asp

Baseball-style arbitration

Annex A indicates that the arbitration will be binding and will be “baseball-style” or “last-best-offer” arbitration. Thus, the arbitrators must choose between one of the parties’ positions and cannot substitute their own position.²²

Applicable legislative or quasi-legislative rules

The arbitration board is to apply, as necessary:

- the provisions of the Convention
- any agreed commentaries or explanations concerning the Convention²³
- the laws of the United States and Canada “to the extent that they are not inconsistent with each other”
- the 1995 OECD Transfer Pricing Guidelines²⁴ and relevant Commentary to the OECD Model Convention.

No precedent

As with other MAP cases, arbitration proceedings and their determinations are stated not to have precedential value.²⁵

Double tax cases eligible for arbitration Accelerated competent authority procedure (ACAP) cases

Taxation years for which ACAP has been requested are eligible for arbitration at the same time as the earlier taxation years for which the related MAP request was made.

Advance pricing agreement (APA)

Bilateral APAs are eligible for arbitration. For APA years for which tax returns will have been filed in both countries for at least 12 months (including rollback years) before arbitration begins, the arbitration board’s determination will simply be an amount of income, expense or tax reportable to Canada or the United States. For taxation years for which tax returns have not been filed for at least 12 months in both countries, the transfer pricing methodology for the APA will be the one described in the proposed resolution selected by the arbitration board.

There is, however, a singularity with respect to the commencement date of APA MAP cases that we will discuss further below under the heading “commencement date”.

Cases ineligible for arbitration

The MOU provides a list of cases that the competent authorities will *not* entertain for arbitration. This list includes cases that meet the following criteria.

- The taxpayer has not otherwise complied with domestic requirements for MAP (i.e. as set out in the current versions of Information Circulars 71-17 and 94-4 in Canada and Revenue Procedures 2006-54 and 2006-9 in the United States).
- A court decision has been rendered on the case in Canada or the United States.
- The taxpayer has agreed with the Appeals section of the relevant tax authority, or with Chief Counsel in the United States, to a settlement or closing agreement for the case.
- Both competent authorities have agreed that the case is not suitable for arbitration before the arbitration starts.
- Court proceedings have commenced in either Canada or the United States
- The six-year notification under Article IX(3)(b) was not provided.

No unilateral rejection

Another helpful enhancement of the MAP process introduced by the MOU is that, once a MAP request is accepted, “neither competent authority will cease unilaterally to consider a case,” unless the case is otherwise ineligible for arbitration under the MOU.

Commencement date

For non-APA MAP cases, the two-year timeframe starts with the commencement date and (unless the two competent authorities agree on another date) ends two years later with the start of arbitration. The commencement date is defined as “the earliest date on which the information necessary to undertake substantive

Arbitration will be binding and will be “baseball-style” or “last-best-offer” arbitration. Thus, the arbitrators must choose between one of the parties’ positions and cannot substitute their own position.

²² Paragraph 8 of Annex A.

²³ This should include the Technical Explanations as well as the Memoranda of Understanding signed between the US and Canadian competent authorities in 2005.

²⁴ The stated reference to the OECD Guidelines is for 1995, but, as a practical matter, subsequent amendments are likely to be taken into account.

²⁵ Annex A, paragraph 10.

consideration for a mutual agreement has been received by both competent authorities” (see Article XXVI(7)(b)).

In contrast, for APA MAP cases, the commencement date is the earlier of:

- the date on which the competent authorities have exchanged position papers, or
- “two years from the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities”

To illustrate this point, consider the following. For all non-APA MAP cases, the two-year timeframe starts with the commencement date and ends two years later with the start of arbitration (unless the two competent authorities agree on another date). The commencement date is defined at paragraph 7(b) of Article XXVI of the Canada-US Tax Convention as “the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities.” In contrast, for APA MAP cases, paragraph 19(d) of the MOU changes the definition of commencement date and indicates that, for such cases, the commencement date “will be the earlier of i) the date on which the competent authorities have exchanged position papers setting forth their initial negotiating positions or ii) two years from the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities.”

Even if the commencement date for APA cases was to be on the day initial negotiating positions are exchanged by the competent authorities, that exchange only occurs quite a while after the two competent authorities have received the information necessary to undertake substantive consideration of the case and after having performed the due diligence/fact-finding portion of the APA which, in practice, takes at least one and sometimes two years. Thus, even under that scenario,

the commencement date for APA MAP cases would be at least one year later than for other MAP cases for which the commencement date is the day on which the information necessary to undertake substantive consideration of the case has been received. Furthermore, if the earlier date under paragraph 19(d) of the MOU is determined by ii), then it means that APA MAP cases are essentially tracking a four-year timeframe as opposed to the two-year timeframe provided under paragraphs 6 and 7 of Article XXVI of the Canada-US Tax Convention. This is because the MOU changes the definition of commencement date for APA MAP cases by delaying it by two years from the date on which the information necessary to undertake substantive consideration of the case has been received, rather than maintaining that date as the commencement date for all cases.

In other words, instead of keeping the commencement date as the date on which the information necessary to undertake substantive consideration of the case was received by the competent authorities, the MOU inserts a two-year delay from that date to the commencement date for APA MAP cases, and arbitration only starts after another two years after that commencement date, thus resulting in a four-year timeframe.

Confirmation of commencement date

The MOU suggests that the competent authorities should either confirm whether they believe they have received enough information to consider a MAP request (and thus confirm the commencement date) or inform a taxpayer that the MAP request is incomplete within the following timeframes:

- for regular MAP cases, within 30 days after receipt of the information for confirmation or within 45 days for notification of an incomplete submission.

- for APA cases, within 60 days after receipt of the information for confirmation or within 75 days for notification of an incomplete submission.

The MOU does not present these timeframes as mandatory.

Start of arbitration

The MOU confirms that the start of arbitration can be accelerated or delayed by consent of the two competent authorities before the two-year mark following the commencement date. In these cases, the two competent authorities will notify the taxpayer.

Board members' eligibility

The MOU indicates that current Canadian or US government employees (and former employees for up to one year after terminating employment) are not eligible as arbitrators. The MOU further states that potential arbitrators will have significant international tax experience. The MOU provides for substitution of arbitrators during the mandate of the board.

The operating guidelines indicate that, within 10 calendar days of the appointment of the second board member, the board members must contact each other to discuss the appointment of the chair. The two competent authorities will agree to a list of "at least 10 qualified persons who are willing to serve as a chair for a board." The list will be reviewed and revised annually. The two initial board members may select a chair who is not named on the list, as long as they inform the two competent authorities in writing.

Board procedures

The operating guidelines indicate that an arbitration board may adopt any additional procedures necessary for the conduct of its business (as long as they are consistent with Article XXVI). The chair must provide the two competent authorities with a written copy of any such additional procedures.

Proposed resolution and position papers

The MOU specifies that the proposed resolution paper for each issue in a given case should not exceed five pages. The supporting position paper cannot exceed 30 pages. Annexes do not count toward the 30-page maximum, but acceptable annexes only include:

- documents previously provided by one competent authority to the other
- documents previously provided to both competent authorities by the taxpayers or their representatives for use in negotiating the case.

The MOU also specifies that the reply submissions of each competent authority cannot exceed 10 pages.

Failure to file proposed resolution

If one competent authority has filed its proposed resolution paper within 60 days but the other has not, then the submitted proposed resolution will be deemed to be the determination of the board and the chair will advise the competent authorities of this determination on the 61st calendar day after his or her appointment.

Communication with the board

The arbitration rules state that the competent authorities must not communicate with the board other than as specified in the MOU (i.e. in providing the proposed resolution and reply submission) unless the board requests additional information. Such additional information can only be requested from the competent authorities, and it must consist of existing documents. The board may not request new or additional analyses. The board must make the request to both competent authorities and specify a response deadline.

Perhaps the most important benefit of the arbitration proceeding will be that its threat will serve as a strong incentive for competent authority negotiators on both sides of the border to work that much harder at completing MAP cases within the two-year mark.

Specific rules for permanent establishment cases

The MOU and the operating guidelines provide slightly different rules for permanent establishment cases, including:

- a requirement to present the proposed resolution and position paper in a sealed envelope
- a mechanism to terminate the case if the board determines that there is no permanent establishment
- different forms of resolution.

Timeframe to render decision

The MOU says that arbitrators will be paid for no more than three days of preparation and two days of meetings, plus travel days. The Operating Guidelines severely restrict the use of staff and specify that the competent authorities will not remunerate them. Thus, each case should take no more than five working days to resolve once the arbitration board has all the relevant documents.

Taxpayer's rejection of board's determination

If a taxpayer either fails to accept the arbitration board's decision within 30 days of its receipt or decides to withdraw its MAP request, MAP will not be available for the same matter and same years.

Perhaps the most important benefit of the arbitration proceeding will be that its threat will serve as a strong incentive for competent authority negotiators on both sides of the border to work that much harder at completing MAP cases within the two-year mark. In any event, the arbitration proceeding will also put a time limit of 34 months on virtually every MAP case between the United States and Canada.

Contributor:

Joelle Hall
KPMG in Canada
Email: jshall@kpmg.ca

EU Arbitration Convention

The European Union (EU) strives to have a single European market without double taxation. Tax treaties among EU states therefore typically provide for a mutual agreement procedure (MAP) that allows the competent authorities of member states to negotiate adjustments for international tax issues, such as transfer pricing, that may lead to double taxation. However, until the EU Arbitration Convention was established, there was nothing that required the tax authorities to reach an agreement within a specified period of time. As result, double taxation relief could be either delayed for a long time period or simply not provided.

To facilitate faster and more effective double tax relief, the EU member states agreed on the EU Arbitration Convention (EU AC). Because the EU AC was issued as a multilateral convention and not as a directive, the arbitration procedure is outside of the jurisdiction of the European Court of Justice.

The EU AC was adopted on July 23, 1990 and became effective as of January 1, 1995. It was originally concluded for a period of five years and therefore it expired on December 31, 1999. On May 25, 1999, the EU member states signed a protocol to extend the EU AC for an additional five years with an automatic five-year renewal system. The protocol entered into force on November 1, 2004, as the last EU member state deposited its instrument of ratification on August 4, 2004. According to the protocol, there is a retroactive application of the EU AC from January 1, 2000. As a result, pending requests made under the EU AC from this date should be accepted.

The EU AC establishes a procedure to eliminate double taxation arising from profit adjustments made by EU Member States because of:

- a failure to comply with the arm's-length principles between affiliated companies
- an attribution of profits to a permanent establishment not comparable to what might be expected if it were a distinct and separate company engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the company of which it is a permanent establishment.

Procedure of the EU Arbitration Convention

According to the EU AC, a two-stage process is used to eliminate double taxation, as follows:

- First stage: MAP
- Second stage: Arbitration procedure.

First stage: MAP

The EU AC's MAP generally follows the rules of the OECD Model. Under this procedure, a company facing a transfer pricing or permanent establishment adjustment submits its case to the competent authority of the member state in which the company resides or the permanent establishment is situated. The application can be made regardless of the remedies provided by the member state's domestic law. The application must be submitted within three years of the first notification of the action that results or is likely to result in double taxation. The competent authority that has been notified by the taxpayer must then

Until the EU Arbitration Convention was established, there was nothing that required the tax authorities to reach an agreement within a specified period of time. As result, double taxation relief could be either delayed for a long time period or simply not provided.

promptly notify the competent authorities of other affected EU member states. For well-founded complaints, the competent authority will seek to resolve the case by reaching a mutual agreement with the competent authority of any other state concerned.

Second stage: Arbitration procedure

If the competent authorities fail to reach an agreement that eliminates the double taxation within two years, the arbitration process starts. Under the arbitration process, the competent authorities set up an advisory commission, which is obliged to determine how to eliminate the double taxation in question based on internationally accepted arm's-length principles. This advisory commission consists of its chairman, two representatives of each competent authority concerned, and an even number of independent arbitrators to be appointed by mutual agreement from a list of qualified arbitrators nominated by each member state. This commission does not have the power of a supranational judicial body.

In forming its opinion, the advisory commission may ask for information and documentation from the companies and the competent authorities concerned, and each company may be asked to appear or be represented before the advisory commission. The advisory commission has to deliver the opinion within six months from the date the matter was referred to it. After receiving the opinion of the advisory commission, the competent authorities have an additional six months to reach a different agreement. If they fail to do so, the competent authorities must implement the advisory commission's decision.

Revised code of conduct

As a result of the activities of the EU Joint Transfer Pricing Forum (JTPF), the first code of conduct with regard to the EU AC was adopted in 2004. The code is intended to ensure a more effective and uniform application of the EU AC by all EU member states on issues such as:

- the starting point of the three-year period allowed to submit the request for an EU AC

- the starting point of the two-year period of the MAP
- the terms and conditions of the MAP
- the terms and conditions for the arbitration procedure if there is no mutual agreement between the tax authorities within two years (list of independent persons, establishment of the advisory commission, functioning of the advisory commission and opinion of the advisory commission).

The EU Council adopted the code of conduct on December 7, 2004. However, the JTPF continuously reviewed the functioning of the first code of conduct and proposed a revised version that was adopted by the EU Council on December 23, 2009. The key content of the revised code of conduct is discussed below.

Thin capitalization cases

Thin capitalization cases often cover two issues: the interest rate and the amount and characterization of the loan. The EU member states agreed that an adjustment to an intercompany interest rate is a transfer pricing issue that is eligible for EU AC. However, there were different views as to whether adjustments to the amount of the loan are eligible for EU AC. Some member states held that the adjustment of profits related to thin capitalization results from the application of domestic anti-abuse rules while others held that it results from the more general arm's-length rules.

The revised code of conduct clarifies that the EU AC refers to profits arising from commercial and financial relations and that all profit adjustments arising from financial relations, including a loan and its terms, are to be based on the arm's-length principle. As a result, such profits are within the EU AC's scope. However, nine EU member states have made a reservation on this recommendation, namely Bulgaria, the Czech Republic, Hungary, Italy, Latvia, the Netherlands, Poland, Portugal and the Slovak Republic. Further, in the working documents, some EU member states indicate they will analyze this issue on a case-by-case basis. In practice, this often means that EU AC is not available for thin capitalization cases.

Triangular transfer pricing cases

The second issue regarding the scope of the EU AC concerns so-called triangular cases. In principle, an EU triangular case is a case where two EU competent authorities cannot fully eliminate double taxation arising in a transfer pricing case in the first stage of the EU AC procedure because an affiliated company is situated in one or more other member states. For example, an affiliate in Country A sells a car to an affiliate in Country B, which operates as a re-invoicing company and sells the same car to an affiliate in Country C with a 1-percent markup. If the tax authority in Country C proposes a significant downward adjustment to the price, the real issue is between Country C and Country A, even though the transaction being adjusted is between Country C and Country B.

The revised code of conduct indicates that, when an EU triangular case arises, the competent authorities involved should immediately invite the other effected EU competent authorities to take part in the proceedings and discussions, either as observers or active stakeholders. The competent authorities should decide together whether they prefer to follow:

- *a multilateral approach*, involving immediate and full participation of all the competent authorities concerned
- *a bilateral approach*, whereby the two parties involved are the competent authorities with taxpayer affiliates that had significant influence on the issue in the chain of relevant transactions or commercial/financial relations, but with other EU competent authorities participating in the MAP discussion as observers
- *a multiple bilateral approach*, with the other EU competent authorities invited to participate as observers in the MAP discussions. If two or more parallel bilateral procedures are initiated, all

relevant competent authorities should be involved in the first stage of the procedure, either as contracting states in the initial EU AC application or as observers. In the further proceedings, depending on discussions and evidence presented, the status of an observer may change to that of stakeholder. If another competent authority wants to participate in the second stage (arbitration), it must become a stakeholder.

The revised code of conduct states that participating as an observer does not bind the other competent authority to the procedure's final outcome.

Serious penalties

In some cases, tax authorities have imposed "serious" penalties that have resulted in taxpayers being denied access to the EU AC procedure. The revised code of conduct recommends a liberal interpretation of Article 8(1) of the EU AC and invited EU Member States to clarify or revise their unilateral statements in the Annex of the EU AC to better reflect that a serious penalty should be applied only in exceptional cases like fraud.

Advisory commission

Establishing the advisory commission:
Some taxpayers have reported that their cases were not resolved in the proposed three-year period of the EU AC because the competent authorities did not establish the advisory commission. The revised code of conduct states that the competent authorities should establish the advisory commission no later than six months following expiry of the period referred to in Article 7 of the EU AC. Where one competent authority does not do this, the other competent authority involved is entitled to take the initiative.

Composition of the advisory commission:
The advisory commission has to consist of an even number of "independent

For multinational companies, the EU AC procedure is a powerful tool to eliminate double taxation cases within the EU.

persons of standing” (independent arbitrators) in addition to its Chair and the competent authority representatives. Originally, no further guidance was given about the competence or independence requirements of such independent arbitrators. Consequently, EU AC procedures were sometimes delayed because the competent authorities could not agree on which independent arbitrators were eligible for the advisory commission.

The revised code of conduct recommends having the competent authorities draw up an agreed declaration of acceptance and a statement of independence for the particular case for signing by the selected independent arbitrators. To address the concern that some independent arbitrators do not have enough experience with transfer pricing cases, the JTPF agreed that it would consider developing rules to facilitate the assessment of the competence of independent persons of standing at a later stage, after there has been more experience with the process. Note that an independent arbitrator does not have to be a national of or resident in the nominating state, but he or she does have to be a national of a member state and resident within the territory to which the EU AC applies.

Interest charged/credited by tax administrations for EC AC cases

The first code of conduct recommended suspending tax collection during the MAP. The revised code of conduct considered the treatment of interest charges and refunds during the time it takes to complete the EU AC procedure and concluded that a taxpayer should not be adversely affected by the existence of different approaches to interest charges and refunds by the different tax authorities. Therefore, EU member states recommend using one of the following approaches:

- tax to be released for collection and repaid without interest
- tax to be released for collection and repaid with interest
- each case to be dealt with on its merits in terms of charging or repaying interest (possibly during the MAP).

Date from which a case is admissible under the EC AC

Taxpayers located in new members of the EU face the question of whether they are allowed access to the EU AC procedure for issues that originated before their country joined the EU. Article 18 of the EU AC states that EU member states should accept a case that is covered by the EU AC when a timely request is presented after the date of entry into force of accession by new EU Member States to the EU AC, even if the adjustment applies to earlier fiscal years.

Conclusion

For multinational companies, the EU AC procedure is a powerful tool to eliminate double taxation cases within the EU. While there are likely to be difficulties in achieving effective and uniform application by all EU member states, the EU AC helps to establish practical solutions to eliminate double taxation. The EU AC will most likely become even more important in the future as tax audits of transfer pricing issues become more pervasive.

Contributors:

Holger Peters
KPMG in Germany
Email: holgerpeters@kpmg.com

Dirk Van Stappen
KPMG in Belgium
Email: dvanstappen@kpmg.com

Two Key Court Decisions

***GE Capital* – Should Interest Rates and Financial Guarantees be Determined on a Stand-alone Legal Entity Basis?**

The Federal Court of Appeal of Canada (FCA) heard the appeal from the Tax Court of Canada (TCC) transfer pricing decision in *Her Majesty the Queen v. General Electric Capital Canada Inc.* on 16 November 2010 and rendered its decision on 15 December 2010, upholding the TCC's initial decision in favor of GE Capital Canada. The issue in this case was whether the guarantee fees paid by GE Capital Canada to its parent company, GE Capital US, met the arm's-length principle. The TCC had ruled that the one-percent guarantee charged to GE Capital Canada by its parent company was no less than the fee that would have been charged by arm's-length parties under similar circumstances. In doing so, the TCC introduced the notion of "implicit support" in the Canadian transfer pricing landscape by asserting that the implicit support of the parent company had to be taken into consideration in determining the amount of the guarantee fee that would have been charged by an arm's-length party in these circumstances.

The Canada Revenue Agency (CRA) appealed the TCC decision on the basis of various errors of law and fact allegedly made by the TCC and on the basis that the TCC's judge's conduct of the trial resulted in a reasonable apprehension of bias. GE Capital Canada argued that the notion of implicit support had no place in the application of the arm's-length principle in this case.

Looking first at the CRA's grounds for appeal, the FCA agreed with the CRA that the TCC should not have "re-cast the transaction on the basis that the explicit guarantee had, in fact, been removed and assess the impact of the removal." However, the FCA indicated that this error did not alter the TCC's conclusion.

The FCA also found that the error had no impact on the finding that a gap existed between the credit rating which GE Capital Canada would have obtained with and without the explicit guarantee and that the one-percent guarantee fee was within this gap. The FCA found no other errors of law in the TCC decision or any palpable and overriding errors in the TCC's finding that GE Capital Canada would not be able to obtain back-up lines of credit in the guarantee's absence.

Regarding procedural fairness and apprehension of bias, the FCA discarded the CRA's appeal by first pointing out that the TCC did not introduce the notion that the impact of the withdrawal of the guarantee was relevant to the assessment of GE Capital Canada's credit rating. As a result, the TCC's pursuit of the guarantee's withdrawal did not amount to the TCC introducing its own theory of the case. Further, the FCA found that the withdrawal of the guarantee had not played a critical role in the outcome as ultimately decided by the TCC. Finally, even the evidence of the TCC's "excessive pursuit of this issue" did "not establish that bias could reasonably be apprehended against" the Crown.

The TCC's decision that the implicit support payment should be factored into the transfer pricing analysis has much broader transfer pricing implications than the issues raised by the CRA, however. Essentially, this issue raises the questions of (i) whether the benefits of being a member of a group has to be taken into account in a transfer pricing analysis; and (ii) whether transfer pricing analyses can be considered from the perspective of only one party, while ignoring its implications for the other party.

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The FCA viewed GE Capital Canada's argument with respect to implicit support as a "pure question of statutory construction which must be assessed on a standard of correctness." The FCA ruled that it could detect no error in the TCC's finding that implicit support was a factor to be considered when applying the transfer pricing provisions of Canada's Income Tax Act (ITA) (former subsection 69(2) and current paragraphs 247(2)(a) and (c)). The FCA stated that ascertaining the price that would have been paid by parties dealing at arm's length in the same circumstances "involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise." Because the TCC used the yield method to value the guarantee, the FCA also noted that, in the context of that method, "implicit support is a factor which an arm's-length person would find relevant in pricing the guarantee." The FCA went on to say that ignoring implicit support "would require the Court to turn a blind eye on a relevant fact and deprive the transfer pricing provisions of their intended effect."

The FCA also relied on paragraph 1.6 of the OECD Guidelines as well as the July 26, 2010 FCA transfer pricing decision in *GlaxoSmithKline Inc. v. Her Majesty the Queen (GSK)* to support its view with respect to the applicability of the implicit support criteria. The FCA emphasized that the test laid out in *GSK* was that the relevant circumstances in determining the price for an active ingredient to be paid by GSK Canada are the circumstances that an arm's-length party "standing in the shoes of" GSK Canada would consider relevant. The FCA thus concluded that, in "applying this test, there is no doubt that the existence of the implicit guarantee is relevant to the inquiry and must be considered in identifying the arm's-length price."

The FCA did not tie its rationale for considering implicit support back to the legislation. Paragraph 247(2)(c) of the ITA reads as follows:

the terms and conditions made or imposed, in respect of the transaction or series, *between the participants in the transaction* or series had been

those that would have been made between persons dealing at arm's-length [emphasis added]

Because this is the mechanism that the Court should have applied, it is difficult to see how one could reconcile treating GE Capital Canada as if it would benefit from GE Capital US' implicit support while, by virtue of paragraph 247(2)(c), determining the amount payable for the GE Capital US' explicit guarantee (the transaction) to GE Capital Canada (the participants) as if the terms and conditions made or imposed between those participants had been those that would be made between persons dealing at arm's length. Arguably, if they dealt at arm's length, GE Capital US would not provide implicit support to GE Capital Canada. Consequently, this implicit support should not be considered in applying paragraph 247(2)(c) because of its use of the expression "the participants" which requires that the transaction's terms be set between those two parties, GE Capital Canada and GE Capital US, as if they dealt arm's length.

It is troubling that the FCA ultimately turned the mechanism of paragraph 247(2)(c) and consequently the interpretation of the arm's-length principle in Canada into a one-sided analysis. The FCA did so by looking only at GE Capital Canada as if it was getting a guarantee from an arm's-length guarantor rather than from GE Capital US itself, and by not asking under what terms and conditions would GE Capital US agree to provide a similar guarantee to an arm's-length party. This arguably opens the door to one-sided approaches that conclude that the arm's-length principle is met as long as the Canadian taxpayer appears to be earning an arm's-length return regardless of the structure, substance, profitability, functions, risks or assets in respect of the other relevant party or parties to the transaction(s). In other words, the functional analysis need not worry about the non-Canadian side of the transaction. This at least appears to be inconsistent with the requirement in the OECD Guidelines on business restructuring that alternatives have to be evaluated from the perspective of both parties.

A practical aspect of the decision also seems unanswered: even if an implicit support existed that had value, the entity providing the implicit support would do nothing once a formal guarantee is in place until the explicit guarantee has been exhausted. In other words, in GE Capital Canada's case, trying to evaluate the value of an explicit guarantee becomes a

Kafkaesque exercise in light of an implicit support that will never be exercised as a result of the explicit guarantee.

In the end, similar to the TCC decision, while the FCA reached the right result, it is difficult to agree with the application of the notion of implicit support to this fact pattern.

Veritas Software – What Has to be Paid for with the Transfer of Intangibles?

One of the key issues that taxpayers have to consider in determining the value of payments needed for the transfer of intangibles as part of a business restructuring is determining the scope of what has to be paid for – is it limited to the intangible property rights themselves, or does it extend to more broadly defined intangibles such as workforce in place, goodwill and going concern? The impact of this definitional issue on the magnitude of potential payments for such transfers is illustrated in the recently decided US Tax Court case of *Veritas Software Corporation v. Commissioner*.²⁶

This case addressed the buy-in payment made when Veritas Software Corp. and its Irish subsidiary entered into a cost-sharing arrangement (CSA) in 1999. While Veritas had reported a USD 118 million buy-in payment from the subsidiary for intangibles made available to it under that agreement, the Internal Revenue Service (IRS) asserted at trial that the correct buy-in payment was US\$1.675 billion. On December 10, 2009, the US Tax Court decided in favor of the taxpayer.

With its decision in *Veritas*, the Tax Court rejected the IRS's expansive view of intangible assets requiring compensation and its preferred methods for valuing those assets. The *Veritas* decision also reconfirmed the US Tax Court's preference for determining transfer prices based on transactional third-party comparables rather than purely internal financial analysis.

In 1999, Veritas US entered into a cost sharing agreement (CSA) with its subsidiary in Ireland. The CSA consisted of:

- an R&D agreement under which the two parties agreed to pool R&D efforts and to share future costs and risks
- a technology license agreement (TLA) in which Veritas US transferred pre-existing intangible property, such as trademarks and patents, to Ireland in exchange for a buy-in payment and royalties.

In 2000, using the comparable uncontrolled transaction (CUT) method, Veritas US determined that the buy-in payment should be USD 166 million based on royalties paid in third-party agreements that were used as CUT and a limited life for the intangibles. (The buy-in payment was later reduced to USD 118 million, based on updated sales data.) On audit, the IRS determined that the buy-in payment should have been US\$2.5 billion, using the taxpayer's market capitalization as a starting point. During the course of the litigation, the IRS shifted to an income approach based on the present value of residual profits, which led to a buy-in payment of US\$1.675 billion. Both valuations were based on the assumption that the CSA, the TLA, and the parties' conduct were collectively akin to a sale of a business rather than a mere license of specified intangible rights.

As is suggested by the sheer magnitude of the proposed adjustment – the IRS was asserting a buy-in payment that was at

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²⁶ *Veritas Software Corp. et al. v. Commissioner*, 133 T.C. No. 14 (Dec. 10, 2009), Doc 2009-27116, 2009 TNT 236-17.

least ten times greater than that filed by the taxpayer – the taxpayer and the IRS had different views on what had to be paid for in return for the Veritas US' contributions to the CSA. The taxpayer took the position that the key intangible that had to be paid for was the technology used in the software. The taxpayer further held that this technology had a finite life of four years and that the best approach for determining the intercompany price for the transfer was the use of unrelated third-party license agreements that were similar but not identical to the technology covered by the intercompany agreement.

The IRS challenged each of these positions. To start with, following the logic in a Coordinated Issues Paper on cost sharing,²⁷ the IRS distinguished between “make-sell” rights to an intangible asset and “platform rights,” which the IRS defines as the right to use the intangible for purposes of R&D within the scope of the CSA. In its Coordinated Issues Paper, the IRS stated that while make-sell rights decline in value as newly developed products reach the market, “the benefits of the R&D rights conveyed in the platform intangibles typically are expected to span the lives of the intangibles developed as the result of the R&D.”

More fundamentally, the IRS took the view that the transfer of intangibles was akin to the sale of a business. As a result, this value should include (by implication) the value of all related intangibles, including the value of intangibles that were later developed as part of the same business. The IRS adjustment was based on the application of an income method that computed the value of the intangibles as the present value of residual products out to infinity.

As a direct extension of its view that the taxpayer had defined what had to be paid for too narrowly and computed value over too short a life, the IRS asserted that the

license of make-sell rights to a third party typically will not be a CUT for a buy-in payment. In its Coordinated Issues Paper, the IRS states that:

An uncontrolled make-sell license of the fully-developed current generation of a platform intangible is ordinarily distinguishable from the controlled transfer to a CSA participant that gives rise to the obligation to pay a buy-in. A “make-sell” license conveys the rights to exploit an existing intangible. Such a license sometimes provides the transferee a limited right to modify the existing intangible (such as to adapt it for use in a particular geographic market), which may in some cases be classified as “derivative works” under intellectual property law, but importantly it conveys no rights to perform significant further development of the intangible. In contrast, a CSA provides to each cost sharing participant full access to the buy-in intangible for purposes of research, and a CSA is specifically intended to give rise to new intangibles, in which each of the participants has separate ownership rights.²⁸

Finally, as a logical extension of its belief that the transfer of intangibles to the CSA was akin to the sale of a business, the IRS turned to the same highly aggregated approaches to determine the value of the transferred intangibles that are used in the valuation of an overall business enterprise. In doing so, the IRS based its initial US\$2.6 billion dollar valuation on the market value of the overall business and its subsequent US\$1.6 billion dollar value on the present value of the business' forecast residual profits.

In finding in favor of the taxpayer, the Tax Court rejected the IRS' key arguments. The Tax Court rejected the position that the CSA involved platform intangibles with significant value above that of make-sell

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²⁷ Coordinated Issue Paper – Sec. 482 CSA Buy-In Adjustments (LMSB-04-0907-62) (Sep. 27, 2007).

²⁸ Ibid., at Section III.C.

rights. The Tax Court further rejected the argument that platform contributions transferred under the CSA, but not under uncontrolled arrangements, rendered the CUT method used by the taxpayer unreliable. The Tax Court concluded that the useful life of the preexisting intangible property was four years, rather than perpetual. This finding was supported by the uncontroverted opinion of Veritas's software expert that "the amounts of unchanged functional 1999 source code and files were virtually nonexistent within a period of three to four years."

Second, the Tax Court rejected the aggregated approach used by the IRS, stating that the IRS's "'akin' to a sale" theory, which embodies the aggregated approach, "is specious" and that aggregation "certainly does not produce the most reliable result." The IRS asserted that Veritas transferred several valuable intangible assets to Veritas Ireland. Those assets included distribution channels, customer lists, and access to the US R&D team. The Tax Court concluded, "there is insufficient evidence that access to Veritas US' R&D and marketing teams was transferred to Veritas Ireland or had value."

Finally, the Tax Court rejected the IRS argument that the CUP/CUT method was not reliable because the comparable

licensing agreements did not involve a transfer of platform intangibles and so could not provide a reliable method for valuing the required buy-in. The Tax Court in fact carried out a lengthy comparability analysis in which it found that, collectively, the license agreements with the OEMs "did involve essentially the same intangibles that were transferred from Veritas US to Veritas Ireland."

The *Veritas* decision was a clear victory for the taxpayer and an affirmation of the taxpayer's transfer pricing approach. However, the decision will not likely reduce the level of controversy between the IRS and taxpayers on this issue, as the IRS is unwilling to accept that the decision is a correct application of the arm's-length standard. Instead, the IRS has stated that it believes that the Tax Court did not understand the facts and economics at issue in the case and that it will seek another case with stronger facts to litigate on the same legal issues. Further, the IRS has issued new regulations that broaden the definition of what has to be paid for from intangible property to "...all rights, capabilities and resources...." The new regulations incorporate the aggregated business valuation methods that were either rejected or backed away from in the *Veritas* decision.

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Contributor:

Michael Hoffman
KPMG in Canada
Email: mdhoffman@kpmg.ca

Tom Zollo
KPMG in the United States
Email: tzollo@kpmg.com

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KPMG's Global Transfer Pricing Leadership Team:



Sean Foley

Leader – Americas

KPMG in the United States

Email: sffoley@kpmg.com



John Neighbour

Leader – Europe, Middle East, Africa

KPMG in the United Kingdom

Email: john.neighbour@kpmg.co.uk



Kari Pahlman

Leader – Asia Pacific

KPMG in Hong Kong (SAR)

Email: kari.pahlman@kpmg.com



Loek Helderman

Head of Global Tax Efficient Supply Chain Management (TESCM)

KPMG Meijburg & Co in the Netherlands

Email: helderman.loek@kpmg.nl



Notes



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