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Transfer Pricing News

Welcome to the third edition of Transfer Pricing News.

This issue contains transfer pricing updates from a number of countries across the globe – a necessity in the global economy we all now inhabit. So if you want to know about new developments in transfer pricing around the world this is the place to look.

To find out more about the topics featured in Transfer Pricing News do not hesitate to get in touch with the Grant Thornton transfer pricing team. Their contact details are included on the last page of this newsletter.

Go to page...

Australia

Australia releases new transfer pricing rules

On 22 November 2012, the Australian treasury released an exposure draft for the Tax Laws Amendment (cross-border transfer pricing) Bill 2013: Modernisation of transfer pricing rules (new transfer pricing rules), which proposes to overhaul Australia's domestic transfer pricing regime and more closely align it with the Organisation for Economic Cooperation and Development (OECD) transfer pricing guidelines for multinational enterprises (MNEs) and tax administrations (OECD guidelines).

The proposed changes in the new transfer pricing rules represent the second round of transfer pricing legislative reform. Phase one of the transfer pricing rules became law in September 2012 but will become non-operative when the new transfer pricing rules are enacted. Highlights of the new rules are discussed in this article.

The positives:

- the alignment of the new transfer pricing rules with the OECD guidelines, which requires cross-border dealings to be conducted under arm's length conditions
- the introduction of an eight year time limit on when the Australian Tax Office (ATO) can make transfer pricing amendments, with the exception on 'consequential adjustments'. This rule replaces the current unlimited time period for making transfer pricing amendments
- the proposal of thresholds for administrative penalties arising from arm's length principle upon satisfying certain criteria
- the availability of 'consequential adjustments', which grants the ATO the power to make a determination on the consequential adjustment amount for the 'disadvantaged entity' in cross-border dealings.

The key impacts:

- the ability to apply the new transfer pricing rules to all cross-border transactions, including transactions between third parties. This means that all cross-border dealings will be subject to the arm's length principle
- the application of significant penalties to transfer pricing adjustments where the company does not maintain contemporaneous transfer pricing documentation
- aligns the existing transfer pricing regime to the self-assessment taxation system operative in Australia, placing the responsibility on the company's public officer for determining the company's overall tax position arising from all cross-border dealings
- the introduction of specific rules provides the ATO the reconstruction powers to disregard the actual transaction and arrangements, where the actual economic substance of the transaction differs from the legal form
- the allowance for the use of 'a combination of methods' to identify the arm's length conditions that operate between entities dealing cross-border
- the introduction of permanent establishment (PE) rules, governing both foreign PEs operating in Australia and Australian PEs operating offshore, which specifically deals with the attribution of profits with reference made to article seven of double taxation agreements.

What does this mean for the taxpayer?

- increased responsibility on the public officer to ensure that all cross-border dealings appropriately apply the arm's length principle
- increasing complexity and uncertainty for all businesses with cross-border dealings
- the imminent need to prepare contemporaneous transfer pricing documentation to avoid potential substantial penalties
- the need to review all transfer pricing processes and outcomes, both prospectively and retrospectively.

It is unclear whether the government has estimated the full impact that these changes will have on both the Australian and international business community.

Grant Thornton Australia has presented a submission to the Australian treasury outlining its views on the new transfer pricing rules. However, judging from past experience, no significant changes are expected to be made to the proposed legislation before it is passed into law.

MNEs operating in Australia need to be prepared.

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Chile

Transfer pricing is one of the items contained in the recent amendments to Chilean tax law. The Chilean authority decided to use the OECD rules for transfer pricing matters, to regulate transactions with related parties.

The transfer pricing methods that are taken into consideration are: comparable uncontrolled price, resale price method, cost plus method, profit split method and the transactional net margin method.

In order to clarify the meaning of related parties, the law established the following definitions:

- one party that participates directly or indirectly in the management, control, equity, benefits, or incomes of the other party
- person or persons that participate directly or indirectly in the management, control, equity, benefits or incomes of both parties, with the understanding that all of them are interrelated.

PEs are considered to be related with their headquarters, or with any other establishments of the same headquarters. Transfer pricing studies can be used by the taxpayer in order to justify expenses, but in any such case the taxpayer must have the original documents with which the method has been applied or the studies developed if the Chilean internal revenues service requires them.

The Chilean internal revenues service can refuse prices, values and profit when they do not correspond to market prices and apply a tax of 35% on the difference as well as a fine of 5% of said difference.

The amendment of the Chilean tax law also allows taxpayers to enter into advance pricing agreements (APAs). These agreements last three years and are renewable. The taxpayer and the internal revenues service can withdraw without effecting the agreement, when the circumstances taken into account to make these arrangements have changed.

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China

2011 APA annual report issued

On 26 December 2012, the State Administration of Taxation of China (SAT) issued the China advance pricing arrangement annual report (2011) (the 2011 annual report). As the third APA annual report released by the SAT, it follows the framework of the 2009 and 2010 reports while updating the statistics through 31 December 2011. Other additions include statistics related to 'APA renewals signed in 2011' and 'industries covered by signed APAs', revisions which list the factors that the tax authorities might prioritise in an APA request, and the newly included chapter 'SAT contacts (by province) for APA requests' intended to facilitate taxpayers in the submission of APA requests.

New contents in the 2011 annual report

New development of the China APA programme

In 2011, the Chinese tax authorities concluded and signed eight unilateral APAs (including four renewals) and four bilateral APAs. From 1 January 2005 to 31 December 2011, the Chinese tax authorities received 99 written requests or formal applications for bilateral APAs (including 21 agreed APAs). There are 15 countries involved including Japan, Korea, the United States, Denmark and Singapore. In addition, the SAT has received numerous enquiries on bilateral APAs from enterprises. It is expected that the number of APA applications will continue to increase.

Numbers and processing times of renewals

Among the eight unilateral APAs signed in 2011, four of them were renewals. The processing time for renewals has been shortened and most of them were completed within one year.

Industries covered by signed APAs

The report illustrates industries covered by signed APAs in 2005 through 2011. APAs from manufacturing industries are still the majority of the total signed APAs, accounting for 88% with the other industries only accounting for 12%.

Priority of APAs request

Due to the high number of APA applications, in addition to the overall principle of 'first come, first served', the SAT will also consider other factors when making a decision as to whether to prioritise an APA request or not. Such factors mainly include the quality of the request submission, the appropriateness of the transfer pricing method applied and the calculation. Enterprises usually get their application to the SAT rejected due to the insufficient or inaccurate information provided. In addition, whether the applying taxpayer is in a specific industry or located in a specific region that merits prioritised attention is also a factor to be considered.

SAT contacts (by province) for APA requests

Comparing with reports issued in 2009 and 2010, an important addition worth noting in the 2011 report is the SAT contacts by province for APA requests. The report clarifies that in reviewing APAs, the SAT has a strong commitment to mobilise local human capacity and expertise in case examination and analysis. Local personnel are engaged in the APA team for each APA case. The list of contact information further demonstrates the SAT's determination to enhance transparency for the application of APA as well as to serve the taxpayers in a more convenient way.

Statistics

The report proclaims the official statistics on in-process and signed APAs for the period from 1 January 2005 to the end of 2011. The following trends are reflected from the data:

- as an effective way to avoid international double taxation, a bilateral APA is more and more popular among taxpayers
- the number of APAs related to intangible assets or services or finance is increasing rapidly
- the processing time of most signed APAs is less than two years, the efficiency is expected to increase gradually in the future
- more than half of the signed APAs applied the transactional net margin method (TNMM), but the application of other reasonable methods is encouraged by the SAT.

Implications for taxpayers

With the rapid development of economic globalisation and MNEs in recent years, the transfer pricing arrangement between related parties is becoming more and more complicated in both amount and transaction type. As a result, more tax certainty on intercompany transactions is called for by enterprises. These enterprises include multi-national groups investing in China as well as more and more Chinese enterprises which are making overseas investment. As an innovative win-win system for the tax authority and enterprises, APAs are an effective way for enterprises to obtain more legal certainty as well as a powerful tool for tax authorities to have a stable revenue in the future.

The issuance of the 2011 annual report indicates that the SAT attaches importance to the work of APAs and holds a positive supporting attitude toward future development.

As pointed out by the SAT deputy commissioner Wang Li in the preface, the SAT seeks to explore and develop profit allocation concepts which recognise and rightly reflect the contribution of capital and technology importing countries, and applying them in China's transfer pricing and APA practice. Certainty is the highest level of tax services that tax authorities could offer to taxpayers and APAs are aimed at providing the taxpayer with certainty on its transfer pricing.

In addition, the disclosure of SAT contacts for APA requests not only enhances the transparency of the work, but also improves the convenience for application of APAs. Currently the overall administration of APAs is still centralised in the SAT, however, due to serious understaffing, the SAT is actively utilising the resources from local tax authorities. With an effort to enhance the expertise of personnel and the awareness of APAs, the SAT devotes a large amount of resources to training activities including national training, information and experience sharing. With the enhancement of the APA process, it is anticipated that enterprises will be more encouraged and assisted in the application of APAs.

For a taxpayer, all the application documents provided should satisfy the requirements of quality and sufficiency to ensure acceptance and to reduce the processing time. If necessary, the agent could be involved at the initial stage. This is to ensure that the APAs applied for will be accepted as a priority by the SAT.

Since 2005, through the issuance of administration laws and regulations, China has gradually improved its APA system, thus enhancing APA negotiations and allowing increasing numbers of enterprises to apply for the APA. The APA annual report represents one of the key measures the SAT takes to increase the transparency of the APA programme. The SAT hopes it will provide useful guidance to taxpayers to have a good understanding of developments and future trends of China's APA practice, which will be of great importance for enterprises to apply for the APAs in the correct and appropriate manner.

Observations and recommendations

In recent years, the SAT has obtained an important position on the global stage of international anti-tax avoidance. The announcement of the 'China Country Practices' as part of 'Practical Manual on Transfer Pricing for Developing Countries' (draft version) by the United Nations (UN) indicates a great leap in the transfer pricing administration of the SAT. Meanwhile, this initiative broadcasts the transfer pricing issues with Chinese characteristics to a wider audience.

While endorsing the arm's length principle, the SAT will retain its unique approach such as comparability adjustment and the adoption of non-traditional transfer pricing methods. The SAT initially proposed new concepts and methods, i.e., holistic approach and contribution analysis. As such, it could be predicted that in the foreseeable future, the SAT and tax authorities at all levels will prefer to adopt such concepts and methods. However, these concepts and methods are considered to be potentially controversial between tax authorities and enterprises.

The industries (such as automotive, retail and luxury goods), R&D enterprises, and high and new technology enterprises, are highly correlative to the concepts of location savings, market premium, location advantages and local marketing intangibles. The tax authorities are focusing on the transfer pricing practice of the above industries and enterprises, e.g., the tax authorities have already had interviews with the enterprises after obtaining their transfer pricing documentations to explore location savings, market premium, location advantages, local marketing intangibles etc. Management of the above enterprises should review the transfer pricing policies of the enterprises and ensure that the arrangements are in line with the development of China practices. In the context of stringent transfer pricing administration, enterprises in China should consider the views of the SAT and its potential impact on the arrangements of the enterprises. This will enable them to adopt prompt and effective measures with the aim to mitigate the transfer pricing risks in China.

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India

Indian transfer pricing audit issues

The transfer pricing audit cycle in India began in 2004 and since then the issues debated between the income tax department of India (tax authority), which is responsible for the enforcement of transfer pricing rules, and taxpayers have moved from a fairly crude level (mainly based on comparability and numbers) to more difficult issues, the major being marketing intangibles and valuation of shares. This article examines significant audit issues emerging in India.

Marketing intangibles

The transfer pricing aspect of marketing intangibles have been the focus of the Indian transfer authorities over the last couple of years. The issue has been taken up zealously and aggressively by the tax authorities; as a result, many Indian taxpayers have witnessed large transfer pricing adjustments across a number of years on the basis of advertisement, marketing and promotion (AMP) expenditure being asserted to be outside a permissible arm's length range. The common questions raised in all the cases are – 'whether the promotional efforts undertaken by an Indian entity (licensee of trademark) enhance the value of a trademark which is legally owned by an associated enterprise (AE)? Whether the AE should compensate the Indian entity for the excessive AMP expenditure that is attributable to developing a trademark owned by it?' In this aspect, the recent case of LG Electronics considered by a special bench of the tribunal is relevant for discussion. The bench recently gave its verdict and the majority ruling is primarily in favour of the tax authority.

LG Electronics India Pvt. Ltd. (the taxpayer) is a wholly owned subsidiary of LG Electronics Inc. (LGK). LGK allowed the taxpayer to use its brand name and trademark on products manufactured in India. The tax authorities alleged that the Indian entity incurred excessive marketing expenses relative to comparable companies and the excess amount should be treated as brand promotion on behalf of LGK, entitling the taxpayer to be compensated for these expenses with a mark-up. The tax authorities identified the excessive portion of AMP expenses using 'bright line' test. The bright line is determined by comparing the AMP expenses as a ratio of sales of the taxpayer with a similar ratio of AMP expenses of comparable uncontrolled companies. The majority bench endorsed this approach, however referred the particular matter back for redetermination on technical grounds.

The relevance of this case outside India will be apparent to readers in other countries who have heard tax auditors try to assert similar positions. The issue requires a proactive analysis, planning and documentation which can help the taxpayer in assessing and managing this risk.

Share valuation

The concept of 'share valuation' has gained high interest in India for the following reasons:

- transfer pricing aspects of share valuation have received renewed and perhaps a more intense focus in a recent round of transfer pricing audits
- guidance in the Indian regulations, as well as in the OCED is not very detailed
- The Indian regulatory authorities have issued different guidelines regarding the valuation of shares.

In association with the above, recent notices issued by the Income tax department on multi-national companies (MNCs) in India, provide some insights into the approaches adopted by the tax authorities on 'share valuation'. The Indian arms of Vodafone and Shell are some of the big names that have been slammed notices by tax authorities with massive tax demands.

The Indian tax authorities alleged that the shares were issued to the associated enterprise at a price lower than the arm's length price and consequently lower issue price warrants for an adjustment.

Another controversial issue upturned is the treatment of subscription of shares as an unsecured loan by tax authorities, thereby taxing the imputed interest on the undervalued amount.

APA regime

One other beacon of hope is the APA mechanism that has opened its doors from FY 2013-14 onwards and certainly being accessed increasingly by corporates as the due date for filing the first set of APA applications nears, 31 March 2013. The key features of the APA scheme in India are:

Eligibility: any person who has undertaken an international transaction, or is contemplating to undertake an international transaction, will be eligible to apply for an APA.

Threshold: no threshold limit has been prescribed in the APA rules. All the taxpayers entering or proposing to enter into an international transaction have an option to enter into an APA.

Pre filing consultation: the main objective of pre filing consultation is to determine the scope of APA, identify transfer pricing issues, determine the suitability of the international transaction for the agreement and to discuss broad terms of the agreement. Pre-filing is mandatory in India. The option to conduct pre-filing consultation anonymously is also available. Following the pre-filing consultation, and depending on the outcome, an APA application can be filed.

Types of APAs available: the APA scheme has enabled companies to not only opt for unilateral APA, but also for bilateral and multilateral APAs.

Application for APA: the application is to be filed with the director general of international taxation for unilateral APA and with competent authority (CA) of India for bilateral and multilateral APAs. The number of years can be proposed by the applicant but this cannot exceed five years as suggested in the Finance Act 2012.

The rules also provide flexibility to the taxpayer to withdraw an application if desired.

There are a few areas that require considerations such as provision for confidentiality (firewall provisions) and rollback provisions.

The APA authorities have so far shown a positive approach in understanding the concerns of the investors, attempting to share frequently asked questions, conducting public discussions and providing adequate comfort to ensure fair treatment to achieve a mutually agreeable position for both the tax authority and the tax payer in India. A number of pre-filing meetings are currently taking place, which are very positive and transparent and thereby consequently increasing the hope of MNCs to achieve some amount of certainty in a highly litigious environment. Only time will tell once the APAs are concluded to determine the success of the programme.

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Japan

Japan's new transfer pricing checklist

Japan's National Tax Agency (NTA) has recently been increasing its focus on internal corporate governance for tax-related matters. In light of this trend, the NTA began issuing questionnaires on general internal risk policies to large corporate taxpayers. This questionnaire is generally issued by the NTA when visiting relevant companies, and contains questions on internal tax and accounting risk management policies.

The NTA's recent motivation in this area stems from recent activity at the OECD including the release of the 2011 OECD guidelines, which stressed the importance of taxpayer compliance, and the topics raised at the OECD forum on tax administration held in Buenos Aires in January 2012, which emphasised the development of the relationship between tax administrations and large business taxpayers. It is apparent that the NTA is focusing its efforts now to implement more effective tax administration based on these recent developments at the OECD.

The survey recently prepared by the NTA, which is entitled the 'check sheet for confirmation of efforts and achievements on transfer pricing' (the checklist), is intended to evaluate how large taxpayers are managing their transfer pricing and how they are complying with the Japanese transfer pricing rules. The NTA hopes that the utilisation of the checklist will help to raise awareness of the transfer pricing requirements in Japan, which in turn, will motivate taxpayers to make efforts to voluntarily comply with the requirements. The checklist contains 31 questions on the company's knowledge of, and internal management and compliance with, the rules. The company is required to self-assess its awareness of each point on a scale of one (unaware) to four (high level of awareness). The checklist is divided into the following seven areas:

1. Understanding of Japan's transfer pricing rules
2. The involvement of the company's top management in transfer pricing matters
3. Identification or knowledge of issues relating to foreign related transactions
4. The establishment of a global transfer pricing policy
5. The arm's-length nature of the company's intercompany transactions with foreign related parties
6. The parent company's involvement in transfer pricing issues involving foreign related parties
7. Level of communication with the tax authorities.

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The Netherlands

The Dutch transfer pricing landscape was rather stable in 2012, with increasing transfer pricing audit activity by the Dutch tax authorities.

With respect to tax audits and litigation, there has been an increasing focus on:

- business restructurings and risk allocation
- off-shoring intellectual property developed in the Netherlands
- shifting profit away from the Netherlands to captive insurance companies
- arm's length review of the amount of debt financing
- pricing of financial transactions (loans, guarantees, cash pools).

Substance

Substance issues and the policy of the Dutch tax authorities in this respect did have the attention of the Dutch parliament in 2012. The conclusion is an increasing focus on 'substance over form'.

OECD developments

As the OECD transfer pricing guidelines are basically followed by the Dutch tax authorities, the OECD initiatives on intangibles, safe harbours and timing issues will be of critical importance to the Dutch transfer pricing landscape. The following international developments will impact the Netherlands:

- the OECD issued a discussion draft on the transfer pricing aspects of intangibles in June 2012. Businesses (including Grant Thornton member firms) provided comments to this, which were discussed during a public consultation held in Paris by the OECD on 12-14 November 2012. The discussion draft deals with the following four issues:
  1. What constitutes an intangible?
  2. Which parties are entitled to intangible property related return?
  3. How to characterise transactions involving the use or transfer of intangible property?
  4. What is an arm's length value for use or transfer of intangible property?

It is anticipated that a revised version of the discussion draft will be published this year. In this respect, the second issue regarding which parties are entitled to intangible property related return is expected to be significantly revised. During the public consultation the draft guidance on safe harbours and timing issues were also discussed:

- the draft guidance on safe harbours is more positive in regards to the use of safe harbours. The OECD intends to work on safe harbours for low value services in the future.
- the draft guidance on timing issues addresses the two different approaches in applying the arm's length principle:
  - determining prices ex-ante based on information that was reasonably available at the time of transaction
  - determining prices on an ex-post basis testing the actual outcome.

It is expected that the revised guidance on safe harbours and timing issues will be finalised in 2013.

European joint transfer pricing forum

The EU joint transfer pricing forum adopted the report on cost contribution arrangements on services not creating intangible property on 7 June 2012. This report discusses the concept of a Cost Contribution Arrangement (CCA) on services and distinguishes it from intra-group services. It elaborates on the general features for assessing whether the arm's length principle has been applied to CCAs on services not creating intangible property. It is expected that this report will also impact the transfer pricing policy of the Dutch tax authorities.

UN

Furthermore, in 2012 the UN issued its transfer pricing manual for developing countries. One of the objectives of the manual is that it reflects the realities for developing countries at their relevant stages of development. It is of relevance that the drafters of the manual have not found it necessary, or helpful, for it to take a position on wider debates about other possible standards than the arm's length principle.

Although the manual is basically aligned with the OECD guidelines, the discussion of location savings and location specific advantages in chapter five could be considered as deviating from the views presented in the OECD guidelines. In this respect the chapter also discusses that a split of these advantages is envisaged. These views may prove very relevant for the Dutch transfer pricing landscape for MNEs transacting with related parties in developing countries.

Dutch interest deduction limitations

New Dutch interest deduction limitation rules will come into effect for book years starting on or after 1 January 2013. Furthermore, the thin capitalisation rules will be abolished as of 2013. Both developments will be important for the Dutch financial transfer pricing practice.

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Romania

Romania opted to implement provisions of article 80 of the council directive 2006/112/EC (28 November 2006) on the common VAT system of the VAT Directive (anti-fraud measure) for establishing the taxable amount for operations carried out between related parties. These provisions indicate the circumstances for using the market value for the VAT taxable base and are applicable in Romania starting February 2013.

Although in practice there have been cases in the past in which the tax authorities adjusted the VAT tax base as a result of transfer pricing adjustments, in general the taxpayers have appealed successfully the respective adjustments since the VAT provisions in Romania did not provide for the possibility of modifying the VAT taxable base of transactions between related parties.

The transfer pricing rules in Romania are still developing, therefore the tax authorities are trying to align with the European provisions in order to ease the transfer pricing approach to transactions performed between related parties from the EU. In this respect, the Romanian government issued an emergency ordinance on 23 January 2013 that amends the fiscal code starting February 2013. Until now, the adjustments performed by the Romanian tax authorities on transactions between related parties, had an impact only for corporate income tax purposes, however the tax authorities' February 2013 adjustments will have an impact both on the corporate income tax as well as on the VAT corresponding to transactions between related parties.

According to these recent legislative changes, if the supplier or the beneficiary does not have a full deduction right, then the taxable amount will be considered at the market value.

The market value will be used as the taxable amount for supplies of goods or services between related parties, where:

- the consideration is lower than the market value and the recipient of the supply does not have full VAT deduction right
- the consideration is lower than the market value, the supplier does not have full VAT deduction right and the supply is VAT exempt without deduction right
- the consideration is higher than the market value and the supplier does not have a full VAT deduction right.

According to these recent legislative changes, for the purposes of the above VAT provisions, 'market value' represents the total amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a non-related supplier within the territory of the member state in which the supply is subject to tax.

Where no comparable supply of goods or services can be ascertained, 'market value' means the following:

- in respect of goods – an amount that is not less than the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time of supply
- in respect of services – an amount that is not less than the full cost to the taxable person of providing the service.

Considering the above, entities carrying out transactions that are VAT exempt without credit (e.g. insurance companies, credit institutions and other entities) with their related parties will be impacted by these legislative changes.

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Russia

More than a year has passed since the new Russian transfer pricing regulations became effective on 1 January 2012, following federal law #227-FZ dated 18 July 2012.

It should be noted that in the beginning of 2012 taxpayers had lots of questions regarding certain transfer pricing provisions due to difficulties with understanding the law as well as a lack of clarification from the Russian tax authorities. Several months later the situation has changed a little bit.

In 2012 the Ministry of Finance issued guidance on the application of the legislation. The guidance included the following points:

- calculation of the threshold for control
- correlation of thin capitalisation rules and transfer pricing regulations
- sources of information for CUP
- antimonopoly and transfer pricing rules
- interest free loans
- guidance on the content of transfer pricing documentation.

A form of notification on the controlled transactions, as well as, instructions on its drafting and submission were developed and approved by the federal tax service decree dated 27 July 2012. In particular, the notification shall contain the following information:

- the calendar year for which the information on the controlled transactions is provided
- the subjects of transactions
- information on a transaction participants
- revenues (expenses) received (incurred) under the transactions.

Taxpayers are obliged to submit a notification on the controlled transactions performed during 2012, no later than 20 May 2013. However the possibility to shift the deadline to a later date is now being discussed by the Russian government. It should be noted that the transitional period allows companies with controlled transactions under RUR 100million (approx. EUR 2.5million) for the year 2012 and RUR 80million (approx. EUR 1.8million) for the year 2013 to enjoy exemption for filing notification and preparing transfer pricing documentation.

Although generally the Russian transfer pricing rules are in line with the OECD principles, there are a lot of significant provisions which still require further development and clarification. In particular a possibility of grouping of transactions according to the Russian transfer pricing legislation is questionable. Pursuant to Russian legislation, the transfer price should be tested transaction by transaction, and grouping is only allowed for transactions which are 'homogeneous', which implies that goods should be interchangeable. For a company with a wide range of products, a transfer pricing analysis of division by division or product by product basis requires tracking of a high level of financial information and is sometimes impossible due excessive complexity.

There are other disputable issues that could be mentioned, such as uncertainty in interaction of Russian transfer pricing regulations with other taxes (such as VAT and customs duties), absence of cost sharing or cost contribution legislation and thus practical difficulties in applying indirect charging methods and difficulties in assessing intellectual property charges amongst others.

Therefore the new transfer pricing legislation, which brings the Russian transfer pricing practice in-line with international standards, can be viewed as an important indicator of the positive development of Russian tax practices. However further steps need to be taken in order for Russian transfer pricing requirements to become less burdensome, more transparent and easier to comply with.

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South Africa

The challenges faced by today's MNEs in Africa

Due to the uncertain nature of the economic environment, there is pressure on MNEs to decrease their operating costs in order to maintain the profit margins that their shareholders expect. In efforts to minimise their operational costs, MNEs are consistently seeking to optimise their organisational structures by locating their primary manufacturing and distributing activities in low-cost jurisdictions.

In certain cases, these efforts extend to placing their operations and valuable intellectual property in jurisdictions with lower rates of corporate tax or favourable tax exemptions.

From a tax perspective, provided that there is actual substance in the lower tax jurisdictions (i.e. employees, registered office, functions, risks and cost assumption), this may be a defensible corporate strategy. The problem exists however that certain MNEs create structures whereby highly valued intangibles are transferred to artificial entities or goods/services are distributed via artificial entities which exist in terms of 'form' but have negligible economic substance. MNEs may also manipulate their pricing policies in order to move profits to lower tax jurisdictions or jurisdictions in which associated enterprise have assessed losses. In the past, MNEs have managed to significantly decrease their global tax burdens by adopting these schemes. However, more recently, with much emphasis being placed on transfer pricing by revenue authorities worldwide, it is vital that MNEs manage the balance between improving their operating efficiencies and ensuring that they achieve a defensible global tax rate.

The fiscal demands on the governments of developed and emerging countries to raise revenue and prevent tax base erosion have led to a surge of transfer pricing audits and disputes around the world. With the increasing focus of tax authorities on transfer pricing, MNEs must consider the viability of their organisational structures from an economic and tax perspective as current tax cases have stressed the 'substance over form' concept. South African transfer pricing legislation was amended for financial years starting on or after 1 April 2012. The effect of these changes is likely to include closer attention by the South African Revenue Service (SARS) to the entire business arrangement, including which entity actually manages the limited risks. An arrangement which is considered to be artificial, for example, because the South African entity actually manages the risks even though they are limited by agreement, it is likely to fall foul of the new rules. It is therefore important for affected South African companies to carefully consider all aspects of such arrangements and have policy documentation in place to substantiate their business operations and international transactions. Across Africa, there is a similar trend bringing in new legislation including compulsory documentation requirements in some countries.

Tax authorities throughout Africa are starting to coordinate their efforts in transfer pricing audits and are cooperating as never before to exchange information regarding taxpayers and the industries in which they operate. Tax authorities are assisting each other with information requests, multinational audits and simultaneous examinations. This creates an extra burden on MNEs to ensure that their transfer pricing policies are in line with the legislation of the jurisdictions in which they operate.

Improving tax systems throughout Africa

The OECD and the African Tax Administration Forum (ATAF) have recently signed a memorandum of co-operation, agreeing to work together to improve tax systems throughout Africa.

ATAF have expressed their commitment to help African countries build strong, effective and efficient tax systems and counter erosion of their tax bases and with the assistance of the OECD, will gain much aid and support in the area of transfer pricing. As the revenue authorities gain further training and support and increase their efficiencies, so the number of transfer pricing enquires will increase.

In addition to the pressure placed on MNEs by tax authorities, global organisations such as the 'Tax justice network' and 'Action aid' have emphasised that the corporate social responsibility initiatives of MNEs should incorporate efforts to make certain that a fair share of taxation is paid. These organisations are consistently lobbying for a change in reporting standards to require MNEs to report their tax affairs in much more detail in their audited accounts, essentially a profit and loss account, assets and tax charge for every country where they operate, known as country-by-country reporting. The campaigners believe this would give greater transparency to tax avoidance and alleged profit shifting by multinationals, particularly out of developing countries.

A new era of penalties

A final consideration for MNEs is the new era of penalty regimes which MNEs will face should they fail to comply with the transfer pricing regulations. Throughout Africa, transfer pricing provisions are steadily being introduced into fiscal legislation and where countries have set transfer pricing legislation and penalty regimes, these are generally harsh. In Namibia, for example, the penalty levied is 200% on underpaid tax and 20% per annum interest on unpaid tax. MNEs must consider investing in the development of transfer pricing policy documentation in order to substantiate their intergroup transactions and avoid the harsh consequences of a transfer pricing audit, which could result in an adjustment that will lead to an increased tax burden.

Due to the increased scrutiny of tax authorities, several transfer pricing court cases throughout Africa are expected over the next few years. It is vital that companies operating in Africa prioritise the development and maintenance of adequate transfer pricing documentation to reduce their exposure to transfer pricing risk. The table following this article summarises the transfer pricing rules and regulations of the major African countries.

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County	Regulations
Algeria	Transfer pricing legislation is contained in the 2010 'Additional' Finance Act. The 2010 LFC institutes, for companies operating under the 'Direction des Grandes Enterprises' (major company directorate), a requirement to make available all documentation relating to the transfer pricing policies used in respect of transactions with affiliated companies. For all other taxpayers, it is recommended that transfer pricing documentation be available as the tax authorities may, during the carrying out of an audit, request such documentation (no specific documentation guidance is given).
Angola	Transfer pricing legislation is contained in the statute of big taxpayers. The transfer pricing rules will only apply to 'Group A' corporate income taxpayers to be included in a list to be published by ministerial order of the minister of finance. The transfer pricing rules stipulate a mandatory requirement for affected taxpayers to prepare a dossier for each fiscal year where total turnover exceeds 300 million UCFs. The dossier must characterise the relationships and prices established by the taxpayer with the companies with which they have 'special relations'. The transfer pricing dossier must be sent to the tax administration within six months of the date of closing of the fiscal year.
Botswana	Botswana currently has no transfer pricing rules in place. However, in terms of domestic law, the commissioner of taxes has the power to adjust the liability of the taxpayer where he is of the opinion that a transaction, scheme or operation has not been entered into or carried out by persons dealing at arm's length, with the effect of avoiding, reducing or postponing tax liability.
Cameroon	The 2012 finance law provided some modification to the general tax law relating to transfer pricing in Cameroon. Transfer pricing legislation now includes an automatic obligation to produce documentation at the beginning of a tax audit for companies registered with the large taxpayer unit. This obligation only applies if the company has 25% of its capital/voting rights held directly/indirectly by an entity outside Cameroon.
Egypt	Transfer pricing legislation is contained in article 30 of the income tax law. It is a statutory requirement to disclose the transfer pricing methodologies adopted by the taxpayer involved in controlled transactions and justify the application thereof. Taxpayers are required to maintain supporting documentation, which can be requested during a tax audit.

County	Regulations
Ghana	Transfer pricing regulations 2012 (L.I. 2188) document the transfer pricing legislation. All taxpayers who engage in transactions with controlled parties are required to maintain documentation of the transaction for that period. The commissioner general of the Ghana revenue authority may make a request for information upon which a taxpayer must provide contemporaneous documentation relating to the transactions under investigation.
Kenya	Legal notice no. 67 of 2006 and section 18(3) of the income tax act contains the rules relating to transfer pricing. There is no statutory requirement for taxpayers to include copies of their transfer pricing documentation when submitting their annual tax returns. However, such documentation should be provided within 30 days upon request by the Kenya revenue authority.
Lesotho	In Lesotho, there is a specific section (section 113 of the income tax order of 1993, titled 'Transfer pricing') that provides the commissioner with wide discretionary powers to re-characterise transactions between related parties for Lesotho tax purposes. In practice, this section has rarely been used by the Lesotho tax authority and transfer pricing does not appear to be a prominent issue in Lesotho.
Madagascar	There are no formal transfer pricing regulations in Madagascar. Broad anti-avoidance rules apply to prevent related parties from pricing transactions in a manner which could manipulate profits.
Malawi	Transfer pricing rules are contained in chapter 41:01 of the income taxation act: 'Taxation transfer pricing regulations 2009'. There is no formal requirement to submit transfer pricing documentation but account books or any other documentation relevant to the calculation of transfer prices must be provided promptly upon request by the commissioner of taxes.
Mauritius	There is no formal transfer pricing legislation in Mauritius. However, all transactions should be undertaken at arm's length.
Morocco	There is no formal transfer pricing legislation in Morocco, but transactions between related parties should be at arm's length. Two methodologies are generally applied by the tax authorities in determining the reasonableness of transfer prices, the comparable uncontrolled price method and direct assessment based on available information

County	Regulations
Mozambique	There are no formal transfer pricing regulations in Mozambique. However, there are anti-avoidance rules in place which stipulate that the arm's length principle must apply to all transactions entered into between related parties. The tax authorities examine payments made to lower tax jurisdictions to ensure that they are genuine and reasonable.
Namibia	Transfer pricing legislation is contained in section 95A to the Namibian income tax act. Practice note two of 2006 contains guidance on the application of transfer pricing legislation. There is currently no statutory rule requiring transfer pricing documentation to be submitted to the receiver as part of the income tax return. However it is advised that taxpayers prepare and maintain a comprehensive transfer pricing policy document as this may be requested upon a transfer pricing audit.
Nigeria	The 2012 income tax (transfer pricing) regulation number one relates to transfer pricing for Nigeria. According to transfer pricing regulations, all parties who have entered into controlled transactions must record, in writing or on any other electronic device or medium, sufficient information or data and an analysis thereof to verify that transactions meet the arm's length requirement. For each year of assessment a connected taxable person must disclose related party transactions on a transfer pricing disclosure form. This form must be filed along with the income tax returns for each year of assessment.
South Africa	Section 31 of the income tax act and practice note seven relates to transfer pricing for South Africa. There is no statutory requirement to file transfer pricing documentation. However, the annual income tax return requires disclosure relating to transactions with related parties. It is advised that transfer pricing documentation, together with justification for the pricing of transactions, should be prepared and available to SARS on request. Transfer pricing documentation must be submitted on request and must be contemporaneous. SARS may grant a 30-day period for submission however there is no fixed time period prescribed in the transfer pricing regulations. Time limits may vary based on the transactions under review and applications for extended periods may be submitted to SARS.

County	Regulations
Swaziland	There are no formal transfer pricing regulations in Swaziland. However anti-avoidance legislation empowers the commissioner of taxes to adjust the liability of the taxpayer where the commissioner is of the opinion that a transaction, operation or scheme has not been entered into or carried out by persons dealing at arm's length with the aim of avoiding, reducing or postponing tax liability.
Tanzania	Section 33 of the income tax act in Tanzania contains transfer pricing regulations. Parties engaging in controlled transactions are required to prepare disclosures detailing the terms and conditions of the transactions. A summary thereof is required to be submitted alongside the annual tax return. There is no legal requirement to prepare full and complete transfer pricing documentation. However, upon request by the Tanzanian revenue authorities, this must be submitted promptly.
Uganda	Transfer pricing regulations became effective in Uganda as of 1 July 2011. The regulations are modelled on the OECD guidelines. Multinational businesses in Uganda are now required to determine their income and expenditures arising from transactions with related parties in a manner that reflects the arms' length principle. Documentation showing the evidence of the arms' length principle should be in place at the time of filing the company's income tax return for the year in which the transactions were conducted. The revenue authority has however not yet issued guidelines on what documentation should be put in place.
Zambia	Zambian transfer pricing rules require that transactions between related parties be undertaken at arm's length. Should the tax authorities determine that a transaction has not taken place under arm's length conditions, they may replace the actual conditions with arm's length conditions for commercial and financial transactions between related parties.
Zimbabwe	There are no formal transfer pricing regulations in Zimbabwe. For all trading transactions, there is general anti-avoidance legislation which require transactions between related parties to be undertaken under arm's length conditions.

United Kingdom

HMRC and UK tax avoidance

The Chancellor of the Exchequer and Chief Secretary to the Treasury, announced new action to clamp down on tax dodgers and pledged £77million to Her Majesty's Revenue and Customs (HMRC) to 'expand their anti-avoidance and evasion activity, specifically those focusing on offshore evasion and avoidance by wealthy individuals and by multinationals'. The announcement comes after a string of tax avoidance stories in the UK's press. Starbucks, Apple, Amazon and Google, among others, are all being scrutinised for their low corporate tax payments in the UK, despite their assertion that their actions are perfectly legal.

The chancellor's autumn statement outlined that HMRC should be seen to challenge the use of transfer pricing, royalty payments, intellectual property pricing and interest payments to prevent abuse, and also criticised HMRC for being too passive in tackling the tax gap. The government estimates this will bring in an additional £2 billion of tax per year.

As a result of HMRC's new stance, it is expected that MNCs are likely to face an increase in tax audits and assessments in the UK, and managing transfer pricing risk will feature high on MNC's agendas.

Grant Thornton is running a workshop on managing transfer pricing risk and dispute avoidance at the '2013 IBC International Transfer Pricing Summit' and has also written a chapter on this subject, published in Tolley's book, 'UK Transfer Pricing 2012-13'.

Controlled Foreign Companies (CFCs)

The new CFC legislation came into effect for companies with accounting periods starting on or after 1 January 2013. The measures represent a change in approach and the transfer pricing concept of significant people functions (SPFs) are now central to the new rules. Taxpayers may be required to establish if SPFs are carried out in the UK in relation to the CFC business.

The concept of SPFs was introduced in the OECD 2010 report on attribution of profits to PEs. SPFs are not defined further within the CFC legislation, so reliance is placed on the definitions in the 2010 report.

SPFs are people who conduct fundamental business functions that lead to the assumption of risk, the ownership of assets or the on-going management of those assets and risks.

Broadly, under the new rules, any non-UK resident company that is controlled by a UK company will be a CFC. However, there are a number of exemptions that may apply. If none of the exemptions apply and if there are SPFs carried out in the UK, which relate to the business conducted by the CFC, it may be necessary to treat the SPF of the CFC as if it is a UK branch of the CFC and attribute profits of the CFC to the 'branch'.

Therefore it is important to determine what a SPF is and then how to attribute profits to the hypothesised branch, as prescribed in the OECD 2010 report.

General Anti Avoidance Rule (GAAR)

The chancellor's autumn statement confirmed the introduction of a GAAR, aimed at targeting abusive tax avoidance schemes, in the 'Finance Bill 2013'. It is intended to counteract the tax advantage that would otherwise be obtained from such schemes.

Tax arrangements, defined by a main purpose test, are deemed abusive if the double reasonableness test is also met, whereby the arrangements cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions.

The double reasonableness test was refined to attempt to make sure that the GAAR only applied to its intended targets. This has led to the double reasonableness test being updated to clarify the circumstances considered in establishing if arrangements are abusive. Arrangements are not considered abusive if they are in accordance with HMRC accepted practice.

The GAAR provides another mechanism to HMRC in tackling tax avoidance, which can be used with existing legislative targeted anti-avoidance rules (TAAR), such as the UK transfer pricing and thin capitalisation regime. HMRC's draft guidance says the GAAR will apply when other tax measures, such as TAARs, do not prevent a tax advantage from abusive arrangements, although they do not have to be applied in this order.

The draft GAAR clauses of the '2013 Finance Bill' state that the GAAR overrides any priority rules, for example, section 6 of the Taxation (International and Other Provisions) Act (TIOPA) 2010, which gives effect to the UK's double tax agreements (DTAs). In theory, this may allow HMRC to invoke the GAAR rather than challenge a taxpayer under the transfer pricing regime, denying the taxpayer relief under a DTA, but this is unlikely in practice.

Patent box

The 'Patent box' is a new regime effective after 1 April 2013. This enables companies to benefit from a 10% corporate tax rate on profits of qualifying intellectual property (IP). Qualifying IP includes patents granted by the UK and European patent offices.

The UK regime extends further than most other countries. As well as patent royalties received, the UK regime includes profits from products which have a patented item, as well as part of the profit from patented processes and services.

A number of steps must be performed to arrive at the qualifying patent box profit, to which a 10% corporate tax rate can be applied. In determining the qualifying patent box profit, it may be necessary to establish what an arm's length royalty (notional marketing royalty) would be for the 'brand' element or marketing assets within the business i.e. the return attributable to non-technology IP. This is particularly relevant for consumer businesses, where the 'brand' is considered to be important for the sale of goods.

The greater the reward for marketing intangible assets (the higher the arm's length notional marketing royalty), the lower the IP that relates to patented product technology IP, so less of the company's profits would qualify for the 10% corporate tax rate under the patent box regime.

The notional marketing royalty should be considered under transfer pricing principles, and the comparable uncontrolled price and profit split methods are mentioned in HMRC guidance.

OECD transfer pricing consultation on intangibles

Categorising intangible assets was at the centre of discussion at the OECD's meetings in Paris last November, where Wendy Nicholls spoke on behalf of Grant Thornton UK.

One area of debate was around the stipulation in the discussion draft that 'the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles'. There had been concern that the outsourcing of functions would break this 'rule'.

Joe Andrus, head of the OECD's transfer pricing unit clarified the statement, commenting that the controlling or managing of an outsourced function was akin to the performance of the function. An example of this would be a contract research organisation, where the IP owner sets out the terms under which research services are to be provided, but the service provider acts independently when undertaking these services.

The definition of the term 'intangible' as well as the question of who is entitled to 'intangible related returns' remain contentious issues where differences of opinion exist between businesses/advisers and the authorities. The authorities would generally prefer a wide net to provide them with the ability to eliminate potentially abusive behaviour. Businesses/advisers on the other hand have a preference for clear definitions providing certainty and to assist in preventing double taxation. However, businesses very much welcomed the fact that the OECD's 'working party 6' has issued a discussion draft and invited debate at a much earlier stage in its work than in previous projects.

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United States

Most of the present activity in US transfer pricing can be characterised either as anticipated guidance, or public comments by Internal Revenue Service (IRS) officials on various transfer pricing matters. On a positive note, the US APA programme of the IRS reorganised itself internally, about a year ago. In that reorganisation, the APA programme became the Advance Pricing and Mutual Agreement APMA program. This means that the functions of APA and competent authority (CA) negotiations are now combined into one office, under the single management of the APMA director. The immediate result has been positive. The APMA programme closed 140 cases in 2012, a historic high and more than triple the number of agreements approved the year before (only 43 APAs were executed in 2011). The improved case statistics, according to the APMA director, are attributable at least in part to increases in staffing that have helped reduce average workloads and allowed APA team leaders and other employees to work more efficiently. Further, the APMA director has stated that his next goal is to bring down the processing times from the current average of between 41 and 42 months, putting the 'A' back in APA.

The news is not so favourable on the US-India APA front. The Indian government issued new APA guidelines last year, including provisions for bilateral cases. Recently, however, a top IRS official stated that the agency would no longer accept bilateral APA cases. The official noted his frustration with (1) the large number of cases that remained unresolved, and (2) the negotiating position of the Indian CA, wherein India expresses a preference for profit splits rather than cost-plus methods. A number of high-profile taxpayers have cases pending in the US-India negotiating process; only time will tell the fallout from the new IRS reticence concerning APAs for controlled US-India transactions.

In any event, new guidance is anticipated in the form of new administrative procedures (called Revenue Procedures or "Rev. Proc." for short) governing APAs and CA (i.e., double-tax) cases. These new guidelines and procedures are highly anticipated, but not yet published. As the IRS works to revise its APA and CA guidance, the agency has also stated that it is revisiting a concept that it historically had rejected – that of permitting self-initiated adjustments in competent authority cases. Typically in a CA case, some form of government (rather than taxpayer) action is necessary in order for the USCA to accept a case; the most common example of course is an audit adjustment by the US or a US treaty partner, thus creating the possibility of economic double taxation. Typically, however, the IRS has not accepted for CA consideration any case where the taxpayer has requested double-tax relief in their favour, after the taxpayer itself took some step in another jurisdiction to pay more taxes. The IRS's typical fear here concerns some 'hindsight' or 'tax planning' angle, in which a taxpayer takes the step in order to obtain better results in the US by first approaching a treaty partner to propose an upward adjustment in their foreign tax base. But according to recent public comments, the IRS is apparently rethinking its longstanding 'hard line' approach, to consider cases where double-tax relief could at least be discussed by the competent authorities.

Finally, a large section of taxpayer requests has called for published guidance on transfer pricing for guarantees. The adoption of services regulations several years ago, coupled with recent high-profile court cases, have increased the urgency for new guidance on related-party guarantee fees. Already, the American Bar Association published an extensive white paper, in which it not only explained and analysed all issues concerning the multitude of guarantee transactions, but also suggested transfer pricing methods for addressing those transactions. As with the APA and CA guidance, the IRS has not yet published new guidance – but such guidance is anticipated (hopefully) in the very near future.

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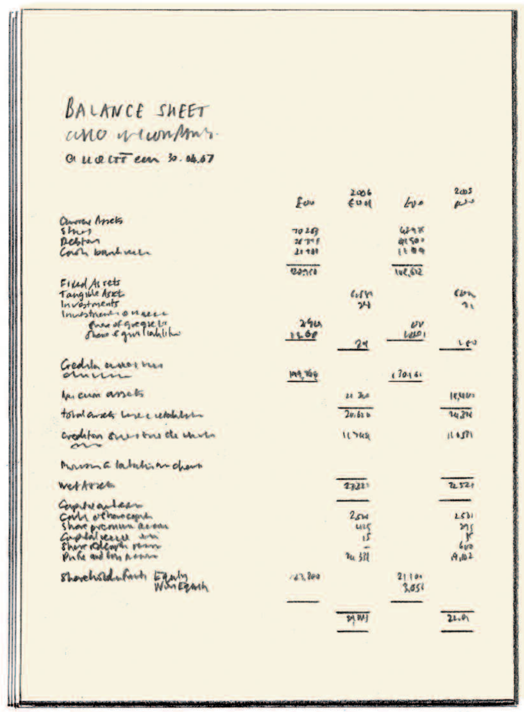

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