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TRANSFER PRICING NEWS

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INTRODUCTION

Transfer pricing is increasingly influencing significant changes in tax legislation around the world. On top of the legislative changes, many important Court cases also deal with transfer pricing. This 12th issue of BDO's Transfer Pricing Newsletter focuses on recent developments in the field of transfer pricing in Brazil, India, Norway, Russia, Turkey and the USA.

We are very pleased to bring you this 12th issue of BDO's Transfer Pricing News, which we were able to produce in close co-operation with our colleagues from the above-mentioned countries.

We trust that you will find it useful and informative. If you would like more information on any of the items featured, or would like to discuss their implications for your business, please contact the person named under the item(s). The material discussed in this newsletter is intended to provide general information only, and should not be acted upon without first obtaining professional advice tailored to your particular needs.

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BRAZIL

TRANSFER PRICING IN BRAZIL

During 2012, the Brazilian Government introduced some important changes in the transfer pricing rules – possibly the most relevant changes since the Law was enacted in 1996. Brazil is not a member of the OECD, and does not follow its rules. Brazilian transfer pricing rules are unique, with fixed formulas and profits, and do not consider any economic, risk or functional analysis.

One of the changes relates to the resale price minus profit method (RPM). Under the previous legislation, transfer pricing was based on the average resale price of the goods applied by the importer in transactions with independent parties, minus unconditional discounts, taxes, brokerage fees and a profit margin of: (1) 60% of the resale price of the final product, minus the deductions mentioned above and less costs aggregated in Brazil by the importer, in the case of imported goods used in the production process or (2) 20% of the resale price of the imported goods, in general.

The margin described in item 1 above has been changed to 40%, 30% or 20%, depending on the economic activity of the company. The 40% margin will apply to pharmaceutical and pharmachemical manufacture, tobacco products, sales of dental/medical/hospital equipment, oil and gas extraction, and the manufacture of petroleum derivative products. The 30% margin will apply to chemical products, glass and glass products, cellulose, paper and paper products, and metallurgy. The 20% margin will apply to other activities. This change will have a great impact on transfer pricing calculations for companies, in that the former 60% margin, in most cases, was resulting in transfer pricing adjustments.

The Government has also created a new method to calculate transfer pricing, known as “Price on Quote”, to be used for import and export transactions. This method will apply to the import or export of commodities (such as cotton, soy, oil, etc.) subject to quotation on internationally accepted commodities and future exchanges. The imported or exported price will be compared to the prices on quote.

The legislation has listed some of the accepted commodities and future exchanges, such as the Chicago Mercantile Exchange (CME), New York Mercantile Exchange (NYMEX), London Metal Exchange (LME), Tokyo Commodity Exchange (TOCOM), Multi Commodity Exchange (MCX), and the China Beijing International Mining Exchange (CBMX).

If no prices are available on commodities and future exchanges, a comparison could be made with information obtained from independent data provided by well known international research institutions such as Platts, Argus, The Metal Bulletin and others.

Interest paid or credited to related parties in relation to intercompany loans will only be considered deductible for income tax purposes if the amount does not exceed the amount calculated based on LIBOR, for deposits in US dollars for a term of 6 months, plus a spread of 3% per year.

The new legislation also clarifies that back-to-back transactions are subject to transfer pricing rules. These transaction relate to the purchase and sale of products that are not physically in Brazil – the product is purchased from a foreign country and sold to a third country without the transit of goods in Brazil. In this case, two calculations (one for purchase and another for sale) are necessary.

The safe harbour rules have also been changed. Companies with profit before tax from export revenue of at least 5% of the total export revenues, on a triennial average, were within the safe harbour and it was not necessary to provide the calculation. However, from 2013 onwards, this percentage is changed to 10% and the safe harbour is only applicable if the net export revenue for related parties represents up to 20% of the total net export revenues. With this new regulation, some companies will certainly be out of the safe harbour.

These are undoubtedly the most relevant changes in transfer pricing legislation since 1996, and the Government is trying to develop the rules and clarify some aspects for companies. It is an important step, but the rules are still not aligned with the OECD transfer pricing guidelines adopted by most jurisdictions. Transfer pricing experts still need to keep a special chapter in their global transfer guidelines for transactions with Brazil.

Your BDO contact in Brazil:
HUGO AMANO
hugo.amano@bdobrazil.com.br

INDIA

SPECIAL BENCH RULING IN LG ELECTRONICS – 'TRANSACTION' DEFINITION TOO WIDE?

On a plain reading of the judgment in the *LG Electronics India Private Ltd* case, advertising, marketing and promotional (AMP) expenses in excess of those in comparable cases are treated as brand building promotional activities. However, this judgment has raised certain interesting thoughts/arguments which are quite different from other judgments on similar lines. In addition, Mr Hari Om Maratha's dissenting opinion has thrown a twist into the judgment.

One of the principal points at issue was whether *incurring higher AMP expenses over and above those in comparable cases are brand building promotional activities for the associated enterprise (AE) and thus it is a "so-called Transaction"*.

This can be analysed as follows:

The word "Transaction" is defined under section 92F of the Income Tax Act for the purpose of the broader definition of "international transaction". In analysing the above section the Income Tax Appellate Tribunal (ITAT) concluded that it is not necessary to have a formal agreement or understanding to prove that an arrangement is to be termed a "transaction". In their analysis, they emphasised that the words "whether or not" at the beginning of the sentence allow them to draw that conclusion.

After having concluded that no formal agreement is required, they went on to analyse the various facts in order to determine whether any arrangement exists; such arrangement would appear to include both implicit and explicit arrangements, whether recorded or not. Here, the emphasis was more on an implicit arrangement. In that connection, the ITAT observed that:

a) If the expenses were incurred for building the brand of the foreign entity, that is in the nature of an implicit arrangement and hence a 'transaction'. At this juncture, the amount of expenditure does not matter. While concluding this, the ITAT overruled the concept of "presumption based transaction" as laid down by the Supreme Court;
b) Even if the expenditure incurred by a company is proportionately much higher, the so-called comparable cases cannot be the basis to conclude that such part of excess expenditure can be attributed to a brand building exercise for a foreign AE. This means, as explained by the ITAT in subsequent paragraphs, that if a company incurs extraordinary expenditure towards AMP but does not display the name of the foreign AE then, irrespective of the amount, it cannot be concluded that there is any so-called implicit arrangement, and hence no 'transaction' with a foreign AE.

The ITAT proceeded to analyse the facts and circumstances, based on these two guiding principles.

Various video clips were produced during the course of the hearings, which demonstrated that LG India's advertising included the logo of the foreign AE and also advertisements of products which are not manufactured by LG India. Further, to strengthen the arguments, the global strategy (Blue Ocean Strategy) of marketing was discussed at length, also highlighting the agreement entered into between the AE and LG India to demonstrate that the Indian company's expenditure is influenced by the AE. Thus, on the above facts, the ITAT concluded that there was an implicit arrangement between them.

The Organisation for Economic Co-operation and Development (OECD) has discussed the circumstances under which a tax officer can disregard a transaction and substitute it with a new transaction. The same principles were also discussed in the judgment of EKL Appliances by the Delhi High Court. In that case, two circumstances were suggested: (a) if the economic substance of the transaction is found to be different from the form, and (b) if the economic substance and the form are the same, then the arrangement made in relation to the transaction has to be looked in totality, whether it differs from what would have adopted by an independent entity behaving in a commercially rational manner.

The same principles were also discussed in the instant case in order to distinguish itself from the EKL ruling.

The discussion was one-sided, emphasising only the commercial factor, as the ITAT categorised it under the second circumstance. The word 'totality' was not properly factored, the reason being that if any company incurs a very high expenditure on so-called AMP, then one has to look at such expenditure, if it helps in contributing to the bottom line of the company or not. If yes, then economically, one is spending the money to earn profit for oneself and not for others. Accordingly, one is justifying the commercial aspect of the OECD guidelines and also looking at the totality. Secondly, one is assuming that in the transactional net margin method (TNMM) analysis the profitability of the company (as a whole) is higher than in comparable cases. If that is so, then the excess (so-called non-routine) expenditure is justified, as the company is earning a higher operating profit. It is also true that almost all of the multinational enterprises (MNEs) operating in India have to use their global logo, which an independent Indian entity (often considered as comparable) cannot use, and MNEs are governed by the global policies of using the same logo.

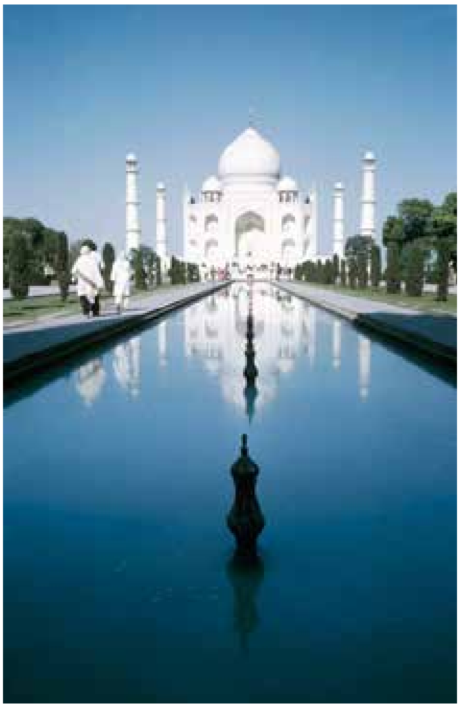
Do ITAT's observations mean that if any company which is manufacturing and selling/ using the technology of the foreign brand owner, that automatically becomes an implicit transaction?

It is true that most large MNEs have one global marketing strategy, and at times they develop common pamphlets, designs and wordings, which are to be used by the global subsidiaries. The global strategy serves as a guide which is to be used by the local entity. It would appear that this does not automatically trigger any influence of the foreign AE in the Indian subsidiary, as most of the time, each jurisdiction is sufficiently independent to take a decision on the approach to be followed. Consequently it fixes its own investment/ budget depending upon the business dynamics of the jurisdiction.

It would appear, with the insertion of sub-section (2A) of section 92CA of the Income Tax Act, function asset and risk (FAR) analysis becomes paramount, and has to be very exhaustive in order to capture any such implicit understanding not only relating to brand building but also various other aspects of the business, including risk. For each company, the fact pattern of the case is very important to analyse and fit into the overall pronouncement of this ruling.

Thus, overall, the judgment has at various places made some critical observations which would be relevant, and is important for all Transfer Pricing practitioners.

Your BDO contact in India:
PARTHO DASGUPTA
parthodasgupta@bdo.in



NORWAY

PROPOSED LIMITATION FOR INTEREST DEDUCTIONS

The Ministry of Finance has proposed limiting interest deductions for loans from related parties.

The proposal

Currently all arm's length interest expenses are deductible. The Norwegian tax authorities wish to reduce the incentives for multinationals to place acquisition debts in Norway and thereby reduce Norwegian tax liabilities. Rules with the same aim have already been introduced in Denmark, Sweden, Finland and other European countries.

The proposal implies that deductions for interest payments to related parties over a threshold of 25% of the company's taxable income, plus the net interest cost and depreciations, would not be deductible for tax purposes.

The calculation can be shown in the following example:

	NOK	
Taxable income (before limitations)	200	Including group contributions
+ Tax depreciation	40	
+ Net interest costs	160	
= Basis of computation	400	
Limit for deductions 25%	100	

For companies with various levels of internal and external debts, the following examples show the effects:

Bank interest NOK	Related party debt interest NOK	Non-deductible amount NOK
0	160	60
100	60	60
110	50	50
120	40	40

The non-deductible amount can be carried forward for five years after the income year, but the carry forward will then cease.

The proposal would affect Norwegian companies with related party debts to foreign shareholders. The rules would apply not only to corporations (AS/ASA), but also partnerships, CFCs (NOKUS-companies), branches and companies owned by government bodies.

Related parties

A related party loan is a loan where the lender and the debtor are directly or indirectly under the same ownership or control of at least 50% at any time in the income year. Accordingly, this includes not only loans from limited liability companies, but also from tax free institutions, funds, state and municipality owned bodies, as well as natural persons.

To avoid any discrimination issues under the EEA agreement with the EU, wholly Norwegian groups are also included.

External party loans

The rules would also cover the following types of external loans:

- Back-to-back arrangements;
- Cash pools; and
- Loans where a related party receives a commission or similar payment from the external lender.

What now?

Companies with a high degree of debt to a related party should undertake an analysis of the proposal and the effects it would have on the group.

The new rules would take effect from 1 January 2014, according to the proposal. Companies with a complicated financial structure may need time to adopt.

Your BDO contact in Norway:
HANS OLAV HEMNES
hans.olav.hemnes@bdo.no

RUSSIA

CHANGES OF TRANSFER PRICING REPORTING DEADLINES

The transfer pricing legislation in Russia is quite new and has been significantly changed since 2012. For instance, the new law first introduced the responsibility of taxpayers to file specific transfer pricing documentation (before 2012 there was no requirement for taxpayers to support the applied prices and prepare any kind of transfer pricing reporting).

Generally the procedure for transfer pricing reporting is as follows:

- Taxpayers should identify controlled transactions and provide general information about them to the tax authorities. The general deadline for such notification is 20 May of the year following the reporting;
- The tax authorities may then initiate a transfer pricing audit based on the information provided to them in the notification (or information they received from local authorities) and request the formal transfer pricing reporting proving the applied prices. Such a request can be made not earlier than 1 June of the year following the reporting year, and the taxpayer then has 30 days to submit the requested documents.

As the law is novel both for taxpayers and the tax authorities, there is a transition period and some of the provisions are implemented gradually. In addition to certain transition period reliefs announced earlier, the Federal Law of 5 April 2013 No. 39-FZ introduced a number of changes to the Tax Code and, inter alia, postponed the transfer pricing filing deadlines for 2012, which are now as follows:

- 20 November 2013 as the deadline for notifying the tax authorities about controlled transactions performed during 2012;
- 1 December 2013 as the first date for requesting official transfer pricing reporting from taxpayers by tax authorities.

Your BDO contact in Russia:
IRINA SHAMRAEVA
i.shamraeva@bdo.ru

Your BDO contact in Russia:
VITALY IVANENKO
v.ivanenko@bdo.ru

TURKEY

INTRA-GROUP SERVICE CHARGES

Formal transfer pricing (TP) rules were introduced in Turkey effective from 1 January 2007.

The local TP rules, under Article 13 of the Corporate Income Tax Law, generally follow the arm's-length principle, established by the OECD Transfer Pricing Guidelines (Guidelines) and are applicable to all financial, economic and commercial transactions and employment relations between associated parties.

Details on the application of Article 13 are set out in a Communiqué on Transfer Pricing (the TP Communiqué).

Turkish local transfer pricing legislation also uses the Guidelines as a basis with regard to Intra-Group Services. In parallel with the Guidelines, the TP Communiqué includes a separate section (Section-11) for Intra-group Services. However, there are certain deviations from the Guidelines, as summarised below.

According to this Section, Intra-group services are:

- Services performed by the corporate headquarters to other related group companies; and/or
- Services that are rendered by one Group Company to other(s).

Conditions

The following conditions must be satisfied in order to determine that the Intra-Group service pricing is in accordance with the transfer pricing rules:

- The service must in fact be rendered;
- The intra-group charge for such services must be in accordance with the arm's length principle; and
- The recipient company(s) must need the services.

The former two conditions were directly derived from the Guidelines and tax rulings; the Turkish Tax Administration follows the interpretation of the Guidelines with regard to these conditions (*i.e. the determination of whether intra-group services have been rendered depends on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position*).

The last condition, stated in the TP Communique, may be regarded as the intention of the Turkish Tax Administration to highlight the importance of the "shareholder activities" issue, as evaluated in Section VII/B1/ 7.9.-7.18 of the Guidelines.

However, in practice this condition may raise more issues than shareholder activities. For example, although the Guidelines deal with this issue as a component of "determining whether intra-group services have been rendered", by demonstrating the scope of shareholder activities, the above-mentioned final condition requires taxpayers to prove that they need to receive the intra-group service.

In several tax rulings, it is stated that deduction of intra-group charges (especially incurred within the scope of cost allocation agreements) would not be allowed where the service agreements and relevant documentation are insufficient to prove that the recipient companies need to receive the services.

Applicable TP Methods

According to TP Communique Section-11/4, Comparable Uncontrolled Price (CUP) and Cost Plus methods supersede other methods (*the Resale Price Method, Transactional Net Margin Method and Transactional Profit Split Method*) regarding intra-group services. Taxpayers may apply transfer pricing methods other than CUP and Cost Plus methods, unless application of these two methods is possible.

Non-compliance with local TP rules

Intra-group charges which fail to satisfy the above-mentioned conditions are to be challenged under transfer pricing rules, and accordingly may be regarded as deemed profits. Such deemed profits are regarded as tax non-deductible expenses from a corporate income tax point of view.

Since these amounts are deemed as dividends, they will be subject to withholding tax, unless the other party is a resident corporate income taxpayer. Pursuant to the local legislation, the withholding tax rate on dividend distributions is 15%.

Furthermore, input VAT on service charges in excess of arm's length value cannot be deducted or recovered.

Your BDO contact in Turkey:
MEHMET YILDIRIM
mehmet.yildirim@bdo.com.tr

UNITED STATES OF AMERICA

NEW REGULATIONS ON OUTBOUND TRANSFERS OF ASSETS

On 13 July 2012, the IRS issued Notice 2012-39 (the "Notice") announcing its intention to issue new Regulations under §367(d). IRC §367 imposes a "toll charge" on outbound transfers of assets in what would otherwise be a tax-free transaction (e.g., tax-free reorganisations, contributions to wholly owned subsidiaries, etc.). IRC §367(d) in particular, deals with outbound transfers of intangible assets, as further explained below. The Notice provides guidance on issues raised when a U.S. corporation transfers intangible property to a foreign corporation in what would otherwise be a tax-free transaction, and provides that the Regulations to be issued under §367(d) will subject certain cash repatriation transactions to immediate U.S. taxation.

Example

The Notice includes a number of examples addressing several types of transactions, and provides the following example as a cash repatriation technique that raises significant policy concerns with the IRS:

> *A U.S. corporation ("USP") wholly owns the interests in a U.S. subsidiary ("UST") and a foreign subsidiary ("TFC"). USP's adjusted basis in its UST stock is USD 100, which equals the stock's fair market value. UST owns an appreciated patent with an adjusted basis of USD 0. UST has no other assets or liabilities. In a reorganisation described in IRC §368(a)(1)(D) (i.e., a "D Reorg"), UST transfers the patent to TFC in exchange for USD 100 of cash. Immediately thereafter, UST distributes the USD 100 of cash to USP in liquidation.*

Prior to the issue of the Notice, taxpayers took the position that neither USP nor UST were subject to immediate U.S. taxation in the D Reorg. USP did not recognise gain, because its basis in UST stock was equal to the stock's fair market value. Taxpayers took the filing position that UST did not recognise gain in the D Reorg under IRC §361(b) because the cash it received from TFC was distributed to USP as part of the D Reorg. IRC §361(b) provides that if a corporation transfers appreciated property to another corporation for cash or property and distributes the cash or property pursuant to a plan of reorganisation, the transferor corporation does not recognise gain on the exchange. Using this strategy, taxpayers repatriated foreign earnings without such earnings being subject to immediate U.S. taxation.

In response to this repatriation technique, the Notice provides that if UST transfers any intangible property described in IRC §936(h)(3)(B) to TFC in exchange for boot (i.e., cash or other property besides TFC stock), the Regulations to be issued will ensure that such boot is treated as a prepayment and currently included in taxable income by UST. In the example above, UST would currently include USD 100 in taxable income.

IRC §367(d) provides that if intangible property is transferred to a foreign corporation in a reorganisation or contribution, the transferor is treated as having sold such intangible property and is required to include deemed royalty payments over the useful life of such intangible property in taxable income. USP, as a qualified successor (i.e., a domestic corporate shareholder of UST that either receives TFC stock in the reorganisation or, immediately after the reorganisation, owns stock of TFC other than stock received in the reorganisation) would step into the shoes of UST and include the "§367(d) payments" over the useful life of the intangible property, but would be able to receive the first USD 100 tax-free because of the USD 100 prepayment included in taxable income by UST. The Notice specifically excludes regulated investment companies, real estate investment trusts, S corporations and individual shareholders from the definition of qualified successor.

If UST has one or more non-qualified successors, UST would include in income an amount equal to the product of (1) the sum of the ownership interest percentages of all non-qualified successors and (2) the amount of gain realised by UST on the intangible property exchanged. To the extent that the intangible property transferred has built-in gain, UST would be required to recognise income regardless of whether any non-qualified successor received cash or other property in the reorganisation.

Foreign goodwill

Hopefully, the IRS will clarify in the Regulations to be issued the application of such rules to foreign goodwill, and whether foreign goodwill is included in intangible property described in IRC §936(h)(3)(B). Section 936(h)(3)(B) provides that the term intangible property means any:

1. Patent, invention, formula, process, design, pattern or know-how;
2. Copyright, literary, musical or artistic composition;
3. Trademark, trade name or brand name;
4. Franchise, license or contract;
5. Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or
6. Any similar item, which has substantial value independent of the services of any individual.

If foreign goodwill is not included in the definition of §936(h)(3)(B) property, it appears that the general rules of IRC §367(a) should apply rather than the rules of IRC §367(d) on an outbound transfer of foreign goodwill. IRC §367(a) would subject UST to immediate taxation on an outbound transfer of foreign goodwill.

If foreign goodwill is included in §936(h)(3)(B) property, pursuant to IRC §367(d)(1)(A), the rules under §367(d) rather than §367(a) should generally apply for §936(h)(3)(B) property. Treas. Reg. §1.367(d)-1T(b) provides that a transfer of foreign goodwill in a reorganisation is not subject to tax under §367(d). If foreign goodwill is §936(h)(3)(B) property, an outbound transfer of foreign goodwill presumably should not be subject to U.S. taxation under either IRC §367(a) (because §367(d) rather than §367(a) applies to §936(h)(3)(B) property) or §367(d) (because the Regulations under §367(d) exclude foreign goodwill from taxation).

The Notice indicates that all property transferred to a foreign corporation will be subject to tax under §367(a) or §367(d). In addition, several government officials have commented that future guidance will clarify that transfers of foreign goodwill are subject to tax under the rules of §367(a). However, these comments appear to be contrary to the legislative history under IRC §367. The legislative history indicates that Congress intended for outbound transfers of foreign goodwill to not be subject to U.S. income tax. "[T]he committee does not anticipate that the transfer of goodwill and going concern value by a foreign branch to a newly organised foreign corporation will result in abuse of the U.S. tax system." House Ways and Means Committee Report on the Tax Reform Act of 1984, H.R. Rep. No. 98-432, pt. 2 (1984).

While the Notice does indicate that all assets UST transfers in an outbound §351 or §361 exchange will be subject to tax under either §367(a) or §367(d), the better view appears to be that outbound transfers of foreign goodwill should not be subject to tax under either §367(a) or §367(d) based on the plain language of the statute and legislative history. Hopefully, the Service will clarify this issue and issue Treasury Regulations consistent with Congressional intent.

Your BDO contact in the USA:
SEAN DOKKO
sdokko@bdo.com

Your BDO contact in the USA:
WILLIAM F. ROTH III
wfroth@bdo.com

CURRENCY COMPARISON TABLE

The table below shows comparative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 7 June 2013.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Indian Rupee (INR)	0.01337	0.01757
Norwegian Kroner (NOK)	0.13133	0.17260
US Dollar (USD)	0.76082	1.00000

LIST OF CONTACT PERSONS

Dan McGeown International Tax Department BDO Toronto	Tel Fax e-mail	+1 416 369 3127 +1 416 865 0887 dmcgeown@bdo.ca
Dirk Elbert International Tax Department BDO Frankfurt am Main	Tel Fax e-mail	+49 69 95 941 438 +49 69 95 941 326 dirk.elbert@bdo.de
Michiko Hamada International Tax Department BDO New York	Tel Fax e-mail	+1 212 885 8577 +1 212 697 1299 mhamada@bdo.com
Anton Hume International Tax Department BDO London	Tel Fax e-mail	+44 207 486 5888 +44 207 487 3686 anton.hume@bdo.co.uk
Sjoerd Haringman International Tax Department BDO Rotterdam	Tel Fax e-mail	+31 10 242 4600 +31 10 242 4624 sjoerd.haringman@bdo.nl