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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. This 14th issue of BDO's Transfer Pricing News focuses on recent developments in the field of transfer pricing in France, India, Indonesia and the Netherlands.

We are very pleased to bring you this 14th 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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FRANCE

NEW DOCUMENTATION REQUIREMENTS

The law relating to the prevention of tax fraud and serious economic and financial crimes (the "**Tax Fraud Law**" No. 2013-1117 adopted on 6 December 2013 and published in the French Official Journal on 7 December 2013) and the Budget Law for 2014 (adopted by the French Parliament on 19 December 2013 and published in the French Official Journal on 30 December 2013) introduced two new transfer pricing documentation requirements.

These modifications aim to strengthen the enquiry powers of the French tax authorities by requiring the routine submission of transfer pricing documentation to the French Tax Administration.

1. New obligation for large companies to submit a light version of their transfer pricing documentation

Under the new Tax Fraud Law provisions, large companies must provide to the French Tax Administration their transfer pricing documentation within six months after filing the French Corporate Income Tax return (Article 223 *quinquies B* of the French Tax Code).

Consequently, transfer pricing documentation needs to be provided voluntarily by French companies each year, and not solely upon request of the French Tax Administration during a tax audit.

However, these new requirements are lighter than those in a tax audit under Article L 13 AA of the French Tax Procedure Code (FTPC). Indeed, such transfer pricing documentation notably includes general information about the group, and specific information on the targeted company such as (i) a list of the intangible assets (trademarks, licenses, etc.), or (ii) a summary statement of intragroup transactions exceeding EUR 100,000. The transfer pricing method should also be detailed.

This obligation only applies to companies meeting the criteria set out under Article L 13 AA of the FTPC, which are as follows:

- Having an annual turnover or net equity exceeding EUR 400 million;
- Owning directly or indirectly, or being owned directly or indirectly by a company meeting the above threshold;
- Being a member of a tax group which includes a company meeting the above threshold.

Penalties for companies that do not comply with this new obligation are very low. Indeed, no specific penalties have been implemented for these new requirements. Hence, currently, the applicable penalties are the standard penalties for failure to fill in a tax return, as follows:

- EUR 150 for failure to submit; or
- EUR 15 for each omission or misstatement.

For fiscal years ending from 31 December 2013, this transfer pricing documentation will need to be provided to the French Tax Administration before the following 5 November.

2. Extended list of information to be included in the transfer pricing documentation

The second provision strengthening the transfer pricing documentation requirements is provided under the Budget Law for 2014.

As a reminder, under Article L 13 AA of the FTPC, since 1 January 2010, large companies (i.e. those meeting the criteria set out under Article L 13 AA of the FTPC) must make their transfer pricing documentation available to the French Tax Administration upon request in a tax audit.

Under the Budget Law for 2014, the list of information to be included in the transfer pricing documentation is extended. French companies need to provide to the French Tax Administration, together with their transfer pricing documentation, all copies of any rulings and advance tax agreements obtained from foreign tax authorities by related companies, irrespective of whether the ruling is linked to the transfer pricing policy.

Although the Budget Law for 2014 introduced a new penalty equal to 0.5% of the turnover of the company which would apply for a failure to provide their transfer pricing documentation, this measure was repealed by the Constitutional Council ("*Conseil Constitutionnel*") by way of its decision No. 2013-685 DC of 29 December 2013.

Therefore, currently, the penalties applicable under Article 1735 B of the French Tax Code are the only applicable penalties, as follows:

- A fine amounting to EUR 10,000; or
- 5% of the profits transferred (depending on the seriousness of the infringement).

It should be noted that a requirement for French businesses operating in France to demonstrate that they had received an "arm's length price" for a deemed transfer of risks or functions, as if such a business restructuring had been made with a non-related party, has been repealed by the Constitutional Council.

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INDIA

SAFE HARBOUR PROVISIONS INTRODUCED

The Indian Revenue has introduced transfer pricing safe harbour provisions in India. It had been noted that the amount of transfer pricing adjustments made by the Revenue was quite high, resulting in uncertainty for taxpayers in relation to transfer pricing and their tax position. The single largest controversy concerned the mark-up for captive software development and back office services.

The resulting litigation led to numerous rulings being made by the tax tribunals in the last 2-3 years. These rulings were mostly in favour of the taxpayer, but various tax tribunal benches took contradictory positions on some tax issues.

The following table lists the safe harbour rates for various services:

Applicability

The rule is applicable for five years starting from assessment year 2013-14 (financial year ending March 2013).

Does the taxpayer have an option?

Every taxpayer can opt for the safe harbour provisions, subject to eligibility as described in the table below with regard to the value of the turnover/transaction and the nature of the services being rendered.

Taxpayers who are eligible to opt for the safe harbour provisions can also decide not to opt for these. In such cases the taxpayers will be subject to a normal transfer pricing audit and documentation requirements, and the arm's length price will not be influenced by the rates prescribed in the table below.

Will the provisions automatically apply under the audit process?

There is no automatic process even for taxpayers who are eligible to opt for the safe harbour provisions – the taxpayer has to apply to the Revenue, using a specific form. The Revenue would then allow the taxpayer to use the provisions, after due verification of the records and eligibility criteria.

Does the tax payer have to maintain documentation?

Yes, the taxpayer has to maintain the documentation required by the legislation, irrespective of whether or not he is opting for the safe harbour provisions. However, the taxpayer does not have to undertake a comparability analysis once he is categorised as eligible for safe harbour purposes.

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Transaction	Ceiling (INR)	Safe Harbour Margin
Software development (other than Contract R&D)	Up to 5,000 million	20% margin on operating cost
	More than 5,000 million	22% margin on operating cost
Information Technology Enabled Service (other than Contract R&D)	Up to 5,000 million	20% margin on operating cost
	More than 5,000 million	22% margin on operating cost
Knowledge Processes Outsourcing (other than Contract R&D)		25% margin on operating cost
Loan to wholly owned foreign subsidiaries (sourced in Indian Rupees)	Less than 500 million	State Bank of India Base Rate plus 150 basis points
	More than 500 million	State Bank of India Base Rate plus 300 basis points
Corporate guarantee on behalf of wholly owned subsidiaries	Above 1,000 million	Commission @ 1.75%
Contract R&D relating to software development	No Ceiling	30% margin on operating cost
Contract R&D relating to generic pharmaceutical drugs	No Ceiling	29% margin on operating cost
Manufacture and Export of core auto components	No Ceiling	12% margin on operating cost for core auto components
	No Ceiling	8.5% margin on operating cost for non-core auto components

INDONESIA

NEW TRANSFER PRICING AUDIT GUIDELINES

The Indonesian Director General of Tax (DGT) has recently issued tax audit guidelines, PER-22/PJ/2013 (PER-22)[1], for taxpayers with related party transactions, with effect from 1 July 2013. The regulations apply to all tax audit proceedings that have not been concluded by the effective date. The guidelines were released as the DGT announced the 2013 tax audit strategy and plan, in which the targets for tax audits include taxpayers with significant cross-border related party transactions.

PER-22 provides guidance on the comprehensive forms to be completed by taxpayers within seven working days during a tax audit. The following key highlights need to be considered:

- Initial profit shifting will be assessed through the comparison of the financial ratio of the audited party against its peers within the industry.
- Analysis of supply chain management including the function, risks and asset profiles, as well as the profitability of the group's entities in the value chain.
- Transfer pricing documentation as one of the bases of review by the Indonesian Tax Authority (ITA) in light of transfer pricing tax audits.
- Comparable uncontrolled price (CUP) method to test interest transactions.
- A requirement of segmented financial data.
- The ITA may select both the transacting parties as tested parties for arm's length test purposes.
- Aggregated approach for transactions that are closely linked or continuous.
- The use of other methods for intangible transactions i.e. income-based, cost-based and market-based approaches.

The six comprehensive forms that must be completed by taxpayer under a tax audit are:

- **Form 1: Transactions with related party(ies)**
  This form is similar to the existing Form 3A that is submitted along with the annual corporate income tax return.
- **Form 2: Segmented financial data**
  The use of segmented financial data was not prescribed by the earlier regulation. This includes direct and indirect segmentation, and the basis of allocation should be defendable.
- **Form 3: Analysis of the supply chain management**
  This form requires disclosure of related parties involved in the supply chain as well as their profitability as participants in the value chain. Taxpayers may encounter difficulty in accessing a group's entities' financial data.
- **Form 4: Analysis of functions, assets and risks**
  A detailed check list of the functional profiles of the tested party and the counter-related party to determine the entity characterisation and the arm's length position, taking into account the profitability of the group's entities participating in the supply chain. Taxpayers may find difficulty in accessing the respective information from the group's entities. Therefore, earlier preparation is suggested in light of time constraints.
- **Form 5: Entity characterisation**
  A statement of the entity characterisation in consistency with Forms 3 and 4.
- **Form 6: Comparability analysis**
  A detailed analysis of the comparability of related party transactions against transactions with third parties, in light of any internal comparables.

Thin capitalisation rules

The Minister of Finance still currently regulates the thin capitalisation rules. Nevertheless under PER-22 the debt-to-equity ratio of the tested party needs to be considered in analysing a related party loan transaction. In our experience of transfer pricing tax audits, it is possible that the ITA would compare the debt-to-equity ratio of the tested party against those of the peers within the industry.

Other methods

If other methods are used for intangible transactions, the existing Form 3A may need an amendment, as the current options are limited to the five methodologies in the special attachment to the corporate income tax return.

Comments

Given the short timeline provided by the tax authorities to complete the detailed questionnaires, taxpayers with significant divergence in their financial ratios compared to those of their peers within the industry may need to address the requirements in advance. This increases the need to incorporate the additional requirements into current transfer pricing documentation.

Requiring information regarding a group's supply chain and functional profiles, as well as the net operating profit of the participating entities in the value chain, may increase the administrative burden and compliance costs to taxpayers. As a consequence, the effectiveness of a tax audit may be reduced by the need to process information that is not relevant to the question at issue. In this regard, the risks could be mitigated by focusing on the provision of documentation for relevant matters.

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[1] *Revokes KEP-01/PJ.07/1993 regarding transfer pricing audit guidelines.*

NETHERLANDS

CHANGES FOR FINANCIAL SERVICE ENTITIES

General

In 2013, following international discussions about the taxation of multinationals, the Dutch State Secretary of Finance submitted a letter to the Dutch Parliament. In view of the states' joint responsibility for transparency and the exchange of information in the battle against tax avoidance and fraud, the Dutch government takes the view that this issue must be dealt with through global solutions and measures.

Nevertheless, recognising its own role in this process, the Dutch government announced measures that focus on the unintended use of Dutch tax treaties. Some of these measures promote transparency and are included in the 2014 Tax Budget.

2014 Tax Budget

Since 2004 there has been a policy decree on the minimum substance requirements for Dutch intermediary companies engaged in (intra-group) royalty and financing activities. This decree applies to those financial service entities seeking up-front approval – advance tax ruling (ATR) – or wishing to conclude an advance pricing agreement (APA) with the Dutch tax authorities.

The application of the minimum substance requirements is now extended to all resident companies that receive royalties, interest, rent and lease premiums from group entities and pay royalties, interest, rent and lease premiums to group entities. A 'group' in this context is defined as entities that are linked by an (in) direct ownership interest of at least 1/3 or have a common shareholder owning (in)directly at least 1/3 in each entity. The general reasoning is that, should a Dutch resident company not meet the minimum level of substance requirements, this company is deemed to be Dutch resident only for tax purposes, i.e. a situation the Dutch government wants to discourage.

Substance requirements

A decree has been issued showing substance requirements that are similar to those in the 2004 decree. The decree applies to companies that have activities that mainly (i.e. more than 70%) consist of the financial intermediary services outlined above. In determining whether the 70% threshold is passed, any holding activities carried out by the entity are ignored. The requirements are:

- Having at least half of the statutory directors with decision-making powers residing or being based in the Netherlands;
- Having directors that have the necessary professional knowledge to perform their tasks properly;
- Management decisions being taken in the Netherlands;
- The (main) bank account of the entity being held in the Netherlands;
- The bookkeeping taking place in the Netherlands;
- Having a registered address in the Netherlands;
- Not at the same time being tax resident in another country;
- The taxpayer is running a real business risk in relation to its financial intermediary services as outlined in article 8c(2) CIT 1969;
- The taxpayer has an equity that is at least appropriate for the risk referred to above.

Non-compliance with the substance requirements

Dutch financial intermediary services entities must confirm – in their annual Corporation tax return – that the substance requirements are met. Failure to correctly indicate that the company does not meet the substance requirements can result in a fine (capped at EUR 19,500).

In the case of non-compliance, i.e. one of the substance requirements is not met, the Dutch tax authorities can pro-actively engage in exchanging information with the relevant foreign tax authorities.

Exchange of information on APAs

Dutch entities that are engaged in financial intermediary services as described above can conclude APAs. The Dutch tax authorities will spontaneously exchange information with the relevant foreign tax authorities in case the Dutch entity, or other group entities, do not undertake activities resulting in more substance than the minimum substance requirements listed above.

Changes for Dutch holding companies

If a Dutch holding company does not meet the minimal substance requirements listed above, the Dutch tax authorities will no longer handle its ATR and APA requests. It should be noted that for groups with a strong intention to meet those requirements, requests will still be processed.

Our recommendation

The new Dutch measures increase the importance of meeting the minimum level of substance requirements. It is, therefore, strongly recommend to (revisit and) review the level of substance in the Netherlands and – if needed – adjust this level to the required standards.

NEW TRANSFER PRICING DECREE

On 26 November 2013 the Dutch State Secretary of Finance published a new transfer pricing decree. The new decree replaces the previous transfer pricing decrees dated 30 March 2001 (IFZ 2001/295M) and 21 August 2004 (IFZ 2004/680M), and contains several new sections in light of specific developments in Dutch case law and the developments with respect to the OECD's project on transfer pricing aspects of intangibles.

Also, in the new decree the application of the arm's length principle, as laid down in the Dutch Corporate Income Tax Act of 1969, remains the starting point. Furthermore, the new decree provides important insights into the Dutch tax administration's position in applying the arm's length principle to specific types of common inter-company transactions, such as:

- Transactions involving (in)tangible fixed assets;
- Centralised purchasing companies;
- Captive insurance companies; and
- Financial transactions.

Furthermore, the decree provides insights in the field of inter-company services and the determination of shareholder costs.

1. Transactions involving (in)tangible fixed assets

Under the new decree the State Secretary elaborates on the importance of functionality of the (legal) owner in order to manage the risks regarding (in)tangible fixed assets. From that perspective, it seems that the new decree is consistent with the recent OECD developments in the field of transferring (in)tangible fixed assets. These developments are focused on situations whereby (in)tangible fixed assets are merely contractually transferred (for example, to a low tax jurisdiction), while there is no relevant functionality with respect to such assets on the buyer's side.

2. Centralised purchasing companies

Since the search for reliable comparables, in order to make a comparison based on a percentage of the value of products purchased, seems to face some difficulties, the new decree states that the Dutch Tax Authorities usually apply the cost-plus method in such situations in order to evaluate the arm's length character of the reward allocated. Therefore the costs of products purchased are not included in the cost base, which as a result merely consists of the purchasing company's own operating expenses.

3. Captive insurance companies

So-called "captive insurance companies" are companies acting as an internal (re)insurance company within a multinational group. Under the new decree, the use of such companies may lead to a non-arm's length shift of profits if the captive insurance company lacks the functions that would be observed within professional insurance companies and/or in the absence of the external diversification of risks. In such cases, the State Secretary considers it appropriate to allocate only a modest reward to the captive company.

4. Financial transactions

As part of evaluating the arm's length criteria regarding financial transactions, whereby it is determined whether the terms and conditions (including the price) under which a transaction is constituted are in line with such terms and conditions that would be agreed upon between independent third parties, the creditworthiness of both parties should also be taken into account.

In this respect credit ratings of 'AAA' to 'BBB-' are considered as highly to sufficiently creditworthy. In the view of the State Secretary it is only in exceptional situations that independent lenders are willing to provide funds to a borrower with a credit rating below BBB-. This results in an increase of the burden of proof in evidencing the arm's length character of the loan.

Furthermore, the State Secretary shares his view on how to determine an interest rate in the case of non-arm's length loans.

5. Guarantees

The new decree states that inter-company guarantee agreements should comply with the arm's length principle if they are to be considered to constitute inter-company services. According to the State Secretary an explicit inter-company guarantee (with respect to a loan) is not considered to constitute a compensable inter-company service in case the borrower would not have been able to obtain the loan without the guarantee of another group company.

If the borrower would have been able to obtain the loan without an explicit guarantee, it should also be evaluated to what extent the borrower would have been able to obtain more favourable terms and conditions (without an explicit guarantee). After all, the group company enjoys a higher creditworthiness solely by being part of a multinational group, enabling the group company to borrow funds on better terms and conditions. In the new decree this is referred to as the implicit guarantee, but again such a guarantee does not constitute an inter-company service which justifies the payment of a guarantee fee. Therefore, this element should also be excluded when determining the guarantee fee.

Furthermore, the amount of the explicit guarantee fee depends on the creditworthiness of the respective group company and the group as a whole. Under the new decree, in principle the guarantee fee cannot exceed the difference between the interest percentage based on the standalone credit rating (not taking the group into account) and the interest percentage based on the credit rating of the group as a whole.

6. Inter-company services and shareholder costs

Like the previous decrees, the new decree contains an important section on the remuneration of inter-company services. Usually these services are remunerated through a cost-based method.

In contrast to the previous decrees, the State Secretary added the statement that it should be established, based on a functional analysis, whether a cost-based remuneration is appropriate. Under the new decree, such remuneration can only generally be used for routine services.

In addition to the above, the new decree explicitly states that activities related to corporate governance will not always constitute shareholder activities. Consequently, these activities may (partly) need to be remunerated at arm's length.

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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 25 February 2014.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Euro (EUR)	1.00000	1.37374
Indian Rupee (INR)	0.01175	0.01614

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