OCTOBER 2009 ISSUE 2
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TRANSFER PRICING NEWS

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INTRODUCTION

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This newsletter focuses on transfer pricing developments at the Organisation for Economic Cooperation and Development (OECD) and in Central and Eastern European countries. More specifically, this second issue provides insights into transfer pricing regulations and trends in the Czech Republic, Hungary, Romania, Russia and Slovenia.

In the Central and Eastern European region, tax authorities are focusing more and more on transfer pricing. In Hungary, for example, the tax authorities set up a special team at the beginning of 2009. This team specialises in reviewing transfer pricing documentation.

Recently, new draft transfer pricing regulations have been published in Russia. Among other things, the draft document outlines new possible methods for determining a market price. Further, Russia aims to introduce a threshold above which information on inter-company transactions should be provided to the tax authorities.

Many tax authorities follow the OECD's Transfer Pricing Guidelines. To catch up with the latest developments at the OECD, this newsletter addresses recent views on transfer pricing in relation to business restructuring and a proposed revision of the Guidelines.

We trust that this issue of the *BDO Transfer Pricing Newsletter* is of interest to you.

RECENT DEVELOPMENTS AT THE OECD

Since many countries follow the OECD Transfer Pricing Guidelines, developments at the OECD are important when establishing transfer pricing. This article focuses on the proposed revision of the Guidelines and recent discussions at the OECD regarding business restructuring.

PROPOSED REVISION OF THE OECD TRANSFER PRICING GUIDELINES

In September 2009, the OECD published a proposed revision of some chapters of the OECD Transfer Pricing Guidelines. This discussion draft represents an important update on comparability analysis and the use of transfer pricing methods.

On the basis of the current Guidelines, many tax authorities prefer the use of the Comparable Uncontrolled-Price Method (CUP), Cost-Plus Method and the Resale-Price Method. The OECD Guidelines qualify other transfer pricing methods as 'methods of last resort'. A major change proposed in the draft is that this hierarchy among transfer pricing methods be abolished. Abolition would expand the freedom for companies to choose a transfer pricing method on the basis of what is most appropriate given the circumstances. This may be e.g. the Profit-Split Method or the Transactional Net-Margin Method (TNMM).

The draft document also provides practical guidance on the application of the Profit-Split Method and on making adjustments to improve comparability. Further, a step plan outlines how a thorough comparability analysis should take place.

TRANSFER PRICING AND BUSINESS RESTRUCTURING

Business restructuring often has an impact on transfer pricing. A business restructuring can relate to e.g. a start-up of new activities, a closure of an existing operation or a relocation of operations. These modifications of business activities can be accompanied by a transfer of functions, risks and assets. As a result, business restructuring may have an impact on the taxable profit of the companies involved and result in taxable transfers or indemnification payments. Further, related reorganisation costs should be allocated in the way that independent parties would allocate these in a similar situation.

Tax authorities in various countries have different views on transfer pricing aspects of restructuring of this kind. Hence, the risk of negotiations and double taxation is high. To reduce these risks, the OECD aims to expand guidance on the transfer pricing aspects of business restructuring. In 2008, the OECD released its first discussion draft on this issue. Recently, the OECD organised a meeting to discuss the draft with the public.

One of the uncertainties companies face is whether the tax authorities recognise the restructuring itself and the new structure. This is especially important in tax-planning situations. Tax authorities might disregard or adjust inter-company arrangements, if they appear not to take place among independent parties. It is still subject to discussion in what exceptional situations tax authorities should be allowed to do so. It was emphasised that companies should be able to organise their business efficiently and effectively even if a third party would behave differently. The guidance in the current OECD draft is not yet considered sufficient for a definitive view to emerge.

A business restructuring may result in the loss of a group company's profit potential. This may be the case e.g. when a manufacturer bearing high risks and owning valuable assets is converted into a limited-risk manufacturer (contract manufacturer). In this respect, it can be argued whether a trade-off between higher but volatile results (i.e. full-risk manufacturing activities) and lower but stable profits (i.e. limited-risk manufacturing activities) should result in a need for compensation. The general view was that profit potential is not an asset. Therefore, the loss of profit potential should not be compensated *per se*. It should be evaluated whether there are rights or other assets transferred that carry profit or loss potential. These should be remunerated at arm's length.

It was outlined that in business-restructuring situations, there should be no presumption that all contract terminations should give rise to indemnification. Legal cases on compensation payments in commercial law are considered to provide valuable guidance. An example for rightful indemnification could be when one contracting party makes significant investments (e.g. in a highly specialised manufacturing facility) to deliver manufacturing services to another group company. If this service contract should be terminated much earlier than expected and as a result it would not be possible for the manufacturer to recover its investment, it is likely the manufacturer would be entailed to some indemnification, assuming the manufacturer has no option other than to write off the assets.

Because many issues are still open to different interpretations and leave much room for uncertainty, the OECD will perform further work taking into account comments from the business community before publishing further guidance.

CZECH REPUBLIC

OVERVIEW OF THE CZECH TRANSFER PRICING REGULATIONS

Transfer pricing rules were introduced in Czech tax legislation in about 1993, strictly along the OECD principles and rules.

There is no legal obligation on the taxpayer to undertake a transfer pricing analysis. However, tax authorities exert pressure on taxpayers through other means to prompt them to show that their relations with related parties are at arm's length.

Taxpayers are offered the opportunity voluntarily to submit an analysis of their business relations and prices vis à vis related parties and apply for a tax ruling. As it is a somewhat cumbersome and costly procedure, only a few companies have applied up to now.

Related case law on transfer pricing is scarce, but what there is reveals victories for both the tax authorities and taxpayers in particular cases.

HUNGARY

LATEST TRANSFER PRICING DEVELOPMENTS IN HUNGARY

The transfer pricing documentation requirement was introduced in Hungary with effect from 1 September 2003. Pursuant to the enabling decree, transfer pricing documentation must be prepared and available in respect of all transactions between related parties by the time the corporate tax return is submitted. Under certain circumstances simplified or consolidated documentation can be prepared.

Previously, the tax authorities have reviewed transfer pricing documentation primarily in terms of form, thus they would check whether the compulsory elements stipulated in the decree of the Minister of Finance, specifying the principles applicable to the preparation of transfer pricing documentation, were included in such documentation.

In the beginning of 2009, a new team specialising in the review of transfer pricing documentation was set up at the Hungarian Tax Administration and, based on the audit principles published by the President of the Hungarian Tax and Financial Control Administration (APEH) in respect of 2009, the review of transfer pricing documentation became a key area. As a result, the examination of the documentation in terms of its content gained importance as well.

A default penalty of up to HUF 2 million (EUR 7475; USD 11 025) per contract may be imposed on companies failing to prepare the required transfer pricing documentation. Based on the various published interpretations, if the affiliated companies did not conclude a contract, it is not obligatory for the tax authorities to calculate the default-penalty base according to the number of unavailable consolidated transfer pricing document sets. They may take into account the default-penalty base according to the number of invoices as well.

Where an external consultant is engaged, on several occasions, the tax authorities examined the receipt of performance related to the invoice issued by the consultant in order to state whether the transfer pricing documentation had indeed been prepared by the deadline when the corporate tax return was submitted.

RUSSIA

NEW CONCEPT OF TRANSFER PRICING RULES

Russian state authorities are currently developing a draft law aimed at establishing significant changes in Russian transfer pricing regulations. In April 2009, the Ministry of Finance announced a new Concept on the development of transfer pricing principles for tax purposes (further referred to as 'the Concept'). This Concept was developed in line with the general tax policy established by the President of the Russian Federation and the Federal Ministry of Finance.

The Concept includes the following principles to be taken into consideration for the development of the respective law on transfer pricing:

- **Affiliated persons.** The list of criteria identifying persons as affiliated is to be extended
- **Controlled transactions.** Currently, the intention is to specify four types of transactions to be controlled by the tax authorities
- Additionally, it is intended to remove the Russian tax authorities' current entitlement to check the proper use of prices in transactions where there is an upward or downward deviation of more than 20% in the level of prices used by a taxpayer in respect of identical (homogeneous) goods (works and services) within a short period of time. This power exists so as to enable the authorities to check whether taxes have been calculated in full
- Transactions between entities consolidated for tax purposes (the law on tax consolidation is currently also in development) will be out of the scope of transfer pricing regulations.
- **New methods of determining a market price.** In addition to the currently established methods (comparable price, cost-plus, resale-minus) the intention is to introduce the secondary product selling-price method, comparable profitability method and the profit-split method. The law will provide for a hierarchy of methods to identify which method shall be applied for each particular transaction.
- **Sources of information on market prices.** In this respect the plan is to extend the list of official sources of information on market prices of goods (works, services) for the purposes of transfer pricing control. Such sources will include world exchange market data, official data from the Russian Federal Customs Service, other Russian state authorities etc.
- **Documentation.** The Concept stipulates that the law on transfer pricing shall contain the list of documentation and other information necessary to confirm the market level of prices applied by the taxpayer and the method under which such level is estimated. Taxpayers shall be liable where they do not provide such information

- **Advance pricing agreements.** The Concept envisages opportunities for taxpayers to agree in advance with the Russian tax authorities the method of pricing and a price level. Provided that the terms of such agreement are observed, no additional tax implications would arise in connection with the prices charged for the transactions involved
- **Provision of information to the tax authorities.** The Concept defines the duty of a taxpayer to provide tax authorities with information regarding controlled transactions carried out within the taxable period, if the total amount of such transactions exceeds a certain limit. In the first year of application of the new rules, the proposal is to fix that limit at RUR 100 million (EUR 2.292 million; USD 3.385 million). In subsequent years it is planned to lower the limit
- **Symmetric adjustment.** New transfer pricing regulations would contain provision on symmetric adjustment, meaning that where the tax authorities have in the course of a tax audit adjusted tax implications for one party to the controlled transaction on the basis of a revaluation of the market price, the other party would have the right to a symmetric adjustment.

It is planned that both the new transfer pricing legislation on the basis of the above Concept and the new tax consolidation legislation should enter into force from the year 2010.

ROMANIA

OVERVIEW OF THE ROMANIAN TRANSFER PRICING REGULATIONS

Romanian tax inspectors have traditionally carefully checked cross-border transactions, and they have been aware of the arm's length principle even before the effective implementation of the transfer pricing provisions. Since accession to the European Union, transfer pricing has become a 'hot topic' in Romania, and there is more and more concern with respect to the potential corporate tax adjustments for local entities.

The Romanian Tax Code and implementing regulation include specific transfer pricing provisions inspired by the OECD Guidelines on Transfer Pricing. Furthermore, there is a direct reference to the OECD Guidelines for the application and interpretation of transfer pricing concepts and regulations. It should be noted that transfer pricing and the taxation of permanent establishments are the only tax areas where OECD Guidelines and commentaries are fully applicable in Romania. Other OECD documents are not binding on Romanian tax inspectors.

At present, the main requirement for local subsidiaries of foreign companies is the preparation of the transfer pricing file. The content of the transfer pricing file has been set according to the Annex of the Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD - 2006/C 176/01). However, Romanian legislation is silent on issues such as the optional character of such documentation for multinational enterprises or the requirement to simplify the documentation for small and medium-sized companies or for non-complex businesses.

Considering the period of limitation in Romania is five years, it is reasonable to assume that cross-border transactions currently being performed should be supported by adequate documentation and transfer pricing methodology. Although transfer pricing provisions have been enforced from 2002, the review of transfer pricing is still inconsistent. In the last year (2008), tax inspectors have required the preparation/presentation of the transfer pricing documentation but without performing an in-depth and comprehensive review of the information it contains. The main consequence is delay in completing tax audits, which might be very inconvenient in the case of VAT refund applications, for example.

SLOVENIA

LATEST TRANSFER PRICING DEVELOPMENTS IN SLOVENIA

Although transfer pricing has been a feature of Slovenian tax legislation since 2005, some rather important developments have taken place in the last few years. The area is regulated according to the OECD rules with some, at first glance minor but in real life rather great, discrepancies.

After 2007, a taxpayer should be able to prove its correct and solid position in transfer pricing by using one of five 'standard' methods. However, before 2007, any other method that would assure a logical and correct supervision of used prices was legitimate and a taxpayer was able to use that method to prove its case. After 2007, however, the law was amended so that no method other than one of the standard five could be used. At first glance, this seems like a minor change but in day-to-day business, it may produce important consequences leading to uncertain position for taxpayers. This becomes evident especially in transactions carried out under innovative regimes. In the area of intangible assets such as intellectual property, the standard methods may soon be exhausted without producing a satisfactory and defensible position. Appropriate methods developed and used elsewhere (for instance in the United States) cannot be used since they do not count as legitimate, no matter that they can assure good results and solid supervision. This keeps taxpayers in uncertainty as to whether defined and used prices match the benchmarking criteria and, as such, count as fair market prices for tax purposes.

As things stand at present (2009), it is still not possible for taxpayers to enter into an APA (advance pricing agreement) with the Slovenian tax authorities, although there is strong and constant pressure on the government to put the necessary infrastructure in place for such agreements in the future. Based on the latest developments, the tax authorities are believed to be planning for this eventuality, and APAs could 'go live' in the next few years. This could be of great importance for taxpayers.

Some new developments have also taken place in the area of official tax inspections. The Slovenian tax authorities have recently developed a questionnaire that is used in transfer pricing inspections (as a checklist and guide). Areas covered by this questionnaire include transfer pricing but in some cases only tangentially. Whether this questionnaire will become a standard element of a transfer pricing inspection is not yet known.

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