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TRANSFER PRICING NEWS

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INTRODUCTION

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Dear Reader

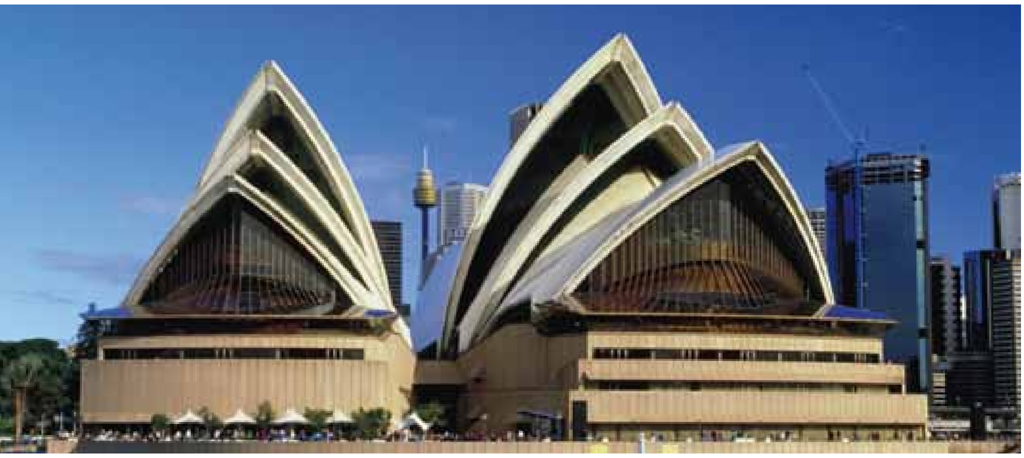
BDO's Transfer Pricing Centre of Excellence is proud to present this 3rd issue of *Transfer Pricing News*, which gives another update on developments in the field of transfer pricing in a number of countries. This 3rd issue contains contributions from BDO Member Firms in Australia, Finland, France, India, Poland, Portugal and Sweden.

Of course, many other countries have new transfer pricing regulations (e.g. Hong Kong and also – shortly – Ireland). There have also been some interesting court cases recently (e.g. in the United States). We intend to inform you about those developments in the next issue of *Transfer Pricing News*.

BDO's Transfer Pricing Centre of Excellence will be organising another transfer pricing seminar, for clients and contacts, in the afternoon of Wednesday 10 February 2010. Venue: the BDO office in Hamburg. Presentations will be given by transfer pricing specialists from BDO in Canada, the United States, the United Kingdom, Germany, the Netherlands and India. If you are interested in attending this seminar, then you are most welcome. Your contact person at BDO can provide you with additional information.

The Transfer Pricing Centre of Excellence of BDO trusts that you will find this issue of *Transfer Pricing News* helpful and informative.

AUSTRALIA



The Australian Taxation Office (ATO) has released Draft Taxation Ruling TR 2009/D6, which addresses the interaction between the transfer pricing provisions and the thin capitalisation provisions. In a separate development, the ATO has also released Draft Practice Statement PSLA 3187 setting out a practical 'rule of thumb' for pricing the interest rate on cross-border related-party loans.

BACKGROUND

The thin capitalisation provisions operate to deny debt deductions (including interest) by an entity to the extent that the entity is thinly capitalised (i.e. has 'excess debt'). In determining whether an entity has excess debt, most entities refer to the 'safe-harbour debt amount', which for most entities permits a maximum debt-to-asset ratio of 75% (subject to certain adjustments).

The interaction between the transfer pricing provisions and the thin capitalisation provisions has been an area that has caused some degree of uncertainty over recent years. Broadly, the issue of concern is whether the transfer pricing provisions may be applied to reduce (or deny) interest deductions where an entity has debt funding from an overseas parent that exceeds the amount that would arise under an arm's length capital structure (i.e. the maximum amount that independent lenders dealing at arm's length with the borrower would lend), notwithstanding that the entity's total debt is less than its safe-harbour debt amount.

TR 2009/D6 now provides guidance on the ATO's approach to this issue and other related matters.

TR 2009/D6

In TR 2009/D6, the ATO rejects the view that if the thin capitalisation provisions do not result in the denial of any interest deductions, the transfer pricing provisions should also not apply to adjust the interest costs. Instead, the ATO states that:

– where an entity does not have excess debt (within the meaning of the thin capitalisation provisions), the transfer pricing provisions may still apply to adjust the interest and other costs directly incurred in obtaining or maintaining the debt funding. The existence of a safe-harbour debt amount does not prevent the Commissioner from determining an appropriate arm's length cost for ***all*** of the debt funding

– however, the transfer pricing provisions cannot be applied to deny deductions ***completely*** for funding costs on debt that is not excess debt for the purposes of the thin capitalisation provisions merely because those deductions relate to a portion of the total debt funding that exceeds the amount that would have arisen under an arm's length capital structure

– any arm's length interest rate worked out under the transfer pricing provisions will be applied to the ***actual*** amount of debt

IMPLICATIONS FOR MEMBERS OF MULTINATIONAL GROUPS

Broadly, the position the ATO takes in TR 2009/D6 is that an entity must ensure that the pricing of all of its international related-party debt be on arm's length terms, even if the entity's total debt does not exceed its safe-harbour amount (requiring analysis of the relationship, terms and nature of the loan).

In situations where there are no readily apparent comparable arm's length prices (because, for example, the debt-funding arrangements in question would not exist between independent parties dealing at arm's length), the ATO will consider an approach that "would lead to a fair result that is as consistent as practicable with the arm's length principle."

Pending finalisation of its position, to assist taxpayers in pricing their cross-border related-party loans, the ATO has stated in Draft Practice Statement PSLA 3187 that it will not raise a transfer pricing adjustment where the interest rate on the loan reflects the usual rate of interest paid by the ultimate parent company applied to the actual amount of debt, provided that it falls within the safe-harbour amount allowed under the thin capitalisation rules.

FINLAND

Finland introduced transfer pricing regulations, including documentation rules, on 1 January 2007. A taxpayer has to produce written documentation annually on transactions with related parties where the other party is foreign and on transactions between a foreign enterprise and its Finnish permanent establishment.

Small and medium-sized enterprises are not obliged to produce written documentation. Such an enterprise is defined as an enterprise with fewer than 250 employees, a turnover of no more than EUR 50 million and a balance-sheet total not exceeding EUR 43 million. It also has to fulfil certain criteria pertaining to the definition of a micro, small and medium-sized enterprise in the European Commission Recommendation 2003/361/EC.

The following information must be provided in the documentation:

1. description of the business
2. description of relations with related parties
3. clarification of transactions between related parties
4. functional analysis on all transactions between related parties
5. comparability analysis including the available information on points of comparison
6. description of the transfer pricing method and its application. Methods to arrive at correct transfer pricing should be based on the methods outlined by the OECD Guidelines

If the total annual amount of transactions between a taxpayer and the other party is less than EUR 500 000, the information mentioned in points 4–6 above is not required.

A taxpayer must present its transfer pricing documentation within 60 days of a request from the tax authorities but no earlier than six months from the end of the last month of the accounting period. Additional and supplementary documentation, for instance information on comparable enterprises, must be presented within 90 days of a request from the tax authorities. All these time limits can be extended.

The Finnish tax authorities have been quite active in monitoring transfer pricing issues after the launch of the rules. Since the rules have been in effect for a short time only, there are no relevant law cases from the administrative courts yet.

FRANCE

NEW TP OBLIGATIONS

As part of new tax anti-avoidance provisions, the Finance Act (Amendment) Act 2009 has made transfer pricing policy in France stricter. New article L.13AA of the French Tax Procedures Code (*Livre des procédures fiscales* – LPF), provides that companies have as from 1 January 2010 the obligation to maintain at the disposal of the tax administration transfer pricing documentation detailing transactions realised with 'associated companies' established outside France.

The obligation applies to companies established in France, if they or an entity of the group of which they are a member, have a turnover or balance-sheet total exceeding EUR 400 million. It also expressly applies to companies benefiting from the worldwide tax consolidation régime.

It also concerns all companies, whatever their size, associated, as defined in article 39(12) of the General Tax Code (*Code général des impôts* – CGI), with a company fulfilling the EUR 400 million size condition.

Under article 39(12) CGI, companies are associated (literally, have 'links of dependence' – *liens de dépendance*) where:

– one company directly or indirectly through a third party holds the majority of the share capital of the other company or in fact exercises the decision-making power or

– a third company directly or indirectly holds the majority of the share capital of both companies or in fact exercises the decision-making power in both

It follows that all medium-sized companies belonging to large groups fall within the provisions and any companies associated with a member of a group of the requisite size will also do so.

When transactions are carried out with associated companies situated in 'non-cooperative states or territories' as defined by article 238-0 A CGI, there is an obligation to maintain complementary documentation. This measure is codified in article L 13 AB LPF.

It should be recalled that, since 1999, in order to help companies secure their economic plans, the tax authorities have been prepared to conclude advance pricing agreements allowing multinational companies to obtain from the tax authorities an advance agreement, negotiated with the proper foreign tax authorities, on the method used to determine the transfer prices that will be applicable to their intra-group transactions.

Article 20 of the Law of 30 December 2004 legalised this procedure by authorising the tax authorities to take a formal position on the determination method of transfer prices. Besides, this text introduced the possibility for the administration to conclude a one-sided TP agreement with the taxpayer. As with the bilateral agreement, the one-sided agreement constitutes a formal and opposable stand from the administration.

CONTENT OF THE DOCUMENTATION

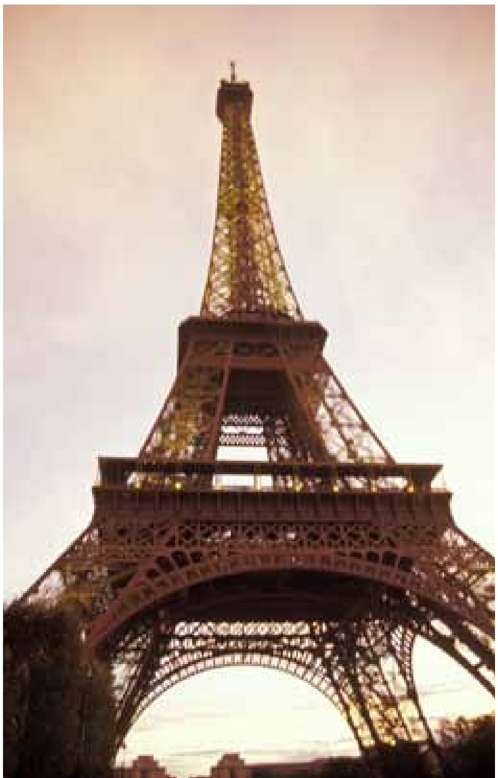
The content and form of the documentation takes its inspiration from the guidelines and recommendations elaborated by the European Union Joint Forum on Transfer Pricing. Two levels of information are required: general information concerning the group of companies and specific information concerning the company under investigation.

The general information must be such as to allow the tax authorities to understand the economic, legal, financial and fiscal environment of the group. It comprises:

– a general description of the company's activity, including all changes that have taken place during the taxable year concerned; all legal and operational structures within the group of associated companies (with identification of such companies) and all functions and responsibilities exercised by the associated companies, to which the company concerned is party

– a list of the main intangible assets (patents, brands, trade names, know-how), held in connection with the company concerned

– a general description of the transfer pricing policy implemented at group level



The specific information concerns elements allowing the administration to gauge whether the company concerned conforms to the principle of full competition. In particular, the activity of the entity, the operations and flows between it and the other entities in the group, the distribution agreements and advance transfer pricing agreements as well as the implemented transfer-pricing determination method and, if necessary, the relevant comparables.

For all transactions carried out with associated companies situated in non-cooperative states or territories, Article L 13 AB LPF requires that the additional documentation contain, for all companies benefiting from those transfers, the same information as required from French taxable companies, e.g. the balance sheet and the income statement (*compte de résultat*) established in conformance with French law.

The new provisions are in force as from 1 January 2010, for all transactions completed from this date. This means that the taxpayer must be able to produce this documentation on first request from the inspector during a tax investigation, and thus on the first day of the audit. If it fails to do so, the taxpayer exposes itself to a formal demand from the administration to present sufficient documentation within 30 days.

In the case of non-compliance with the documentation requirements, a penalty of 5% of the profits considered as transferred abroad will be imposed, subject to a minimum of EUR 10 000 per accounting period. In addition to this penalty, the most important risk is the possibility that the tax authorities will increase the taxable base on the grounds of incomplete and prejudicial information.

INDIA

Given the backdrop of global recession, tax authorities worldwide are under increased pressure by their governments to conserve the tax base. With increasing cross-border transactions and restructuring of businesses, transfer pricing has emerged as a challenging tax issue for both multinationals and the tax authorities.

The Indian revenue authorities are no exception to this global trend, and India has witnessed several rounds of intensive TP audits since the inception of TP provisions in 2001. The tax authorities have been adopting an aggressive approach on TP issues. During the recent audit cycle covering assessment year 2006-07, the revenue department made a transfer pricing demand of INR 100 000 million (approx EUR 1552 million) from as many as 750 companies.

The captive information technology (IT) companies in India, specifically in the software services and the IT enabled services (ITES) areas, have borne the brunt of TP audits. Some of the key TP issues common to taxpayers in India include

- cherry-picking of comparables in captive IT/ITES companies by the revenue authorities
- location savings – the tax authorities argue that the economic benefit arising from shifting of operations to low-cost jurisdictions should accrue to the country where the operations are carried out. The 'offshoring' advantage gets captured in a way by inclusion of high-margin comparables
- use of current (single) year data by the authorities not available to the taxpayer at the time of determining its transfer prices/ TP documentation, as against the multiple-year data used by the taxpayer
- the authorities' preference for the transaction-specific approach over the aggregated approach adopted by taxpayers
- comparability adjustments
  - captive versus entrepreneurs
  - inclusion of companies with embedded tangibles
  - excess capacity adjustment
  - accounting differences
- preference for Indian comparables
- defending the commercial nature of a loss or low profit margin

With the introduction of four key changes, viz the introduction of safe-harbour rules, the Dispute Resolution Panel, variations from the arm's length price in the Union Budget 2009 and the proposed introduction of advance pricing agreements (APAs) in the Direct Tax Code Bill 2009, the Indian TP régime is set to move to the next level.

This brief is an attempt at bringing to you the recent hot topics evolving in the Indian transfer pricing arena.

DISPUTE RESOLUTION PANEL – A FAST TRACK TO RESOLVE TAX CONTROVERSIES

One of the major practical hindrances faced by the assessee during the course of transfer pricing assessments is the long and tedious proceedings in resolving the issues, which may take years before the cases are adjudicated. In the light of this, in 2009, the much-awaited 'Dispute Resolution Panel' (DRP) was introduced to resolve the transfer-pricing assessment issues within a fixed timeline of nine months. Recourse to the DRP is available to all assessees (including foreign companies) who have been aggrieved by an order of the Transfer Pricing Officer (TPO). The DRP's decisions are binding on the tax authorities, but the assessee, if in disagreement with the DRP, may directly approach a higher appellate authority. The clear rationale behind this mechanism is speedy processing of assessments and of course an ulterior motive to encourage foreign investors to venture into a globalisation-friendly jurisdiction!

ADVANCE PRICING AGREEMENTS

APA mechanisms are becoming increasingly available in jurisdictions across the globe. The newly proposed Direct Tax Code, which would replace the obsolescent Indian Income Tax Act 1961, has made way for the début of the APA in the Indian TP Regulations. It has paved the way for entering into an agreement in respect of the arm's length price with the assessee for international transactions. This would be valid for five consecutive financial years unless there is a change in the law or the facts, and binding on the assessee and the tax authorities. It would, however, stand withdrawn upon a change in the law or due to subsequently discovered fraud or misrepresentation by the assessee. The APA mechanism as proposed is intended to reflect the latest and best international TP practice, but its success on roll-out is a matter that only time will tell!

GUARANTEES TO SUBSIDIARIES BROUGHT UNDER THE TP TAX NET

Another transaction that has of late captured the fancy of the Indian tax authorities is where a guarantee is provided to an associated enterprise (within the meaning of section 92A of the Income Tax Act 1961) against a loan taken by the subsidiary abroad, when such guarantee is not accompanied by a commission fee. The Indian TP administrators contend that in line with the international practice of charging a fee ranging from 0.5% to 3%, the associated subsidiaries must act accordingly to compensate the Indian parent for the risks it takes extending the standing guarantee. In addition, the OECD too recommends levying a tax on such guarantees, but this would have to be meticulously examined in light of the Indian commercial scenario and on a case-to-case basis. For the authorities, this is a double-edged sword – they are charged with checking the loss of revenue due to international transactions while at the same time they cannot risk appearing hostile to global business.

PROFIT ATTRIBUTION TO PES BASED ON AN APPROPRIATE BENCHMARKING ANALYSIS

The other practical centre of discussion for any permanent establishment (PE) exposure is profit attribution, where global profits could be allocated by applying Rule 10 (determination of income in the case of non-residents as a percentage of turnover, in the manner that the authorities deems suitable) on the one hand, while on the other hand the OECD report on attribution of profits to PEs recognises the 'functionally separate entity' approach as the 'authorised OECD approach'. Here, the PE is considered as a separate and distinct entity and the specific profits of the PE are computed based on functions, assets and risks assumed by the PE. Even the Indian Transfer Pricing regulations recognise the 'functionally separate entity' approach authorised by the OECD. Thus, in view of the TP regulations and the OECD approach, the profits attributable to a PE should be determined based on an appropriate benchmarking analysis as against apportionment of global profits contemplated by Rule 10.

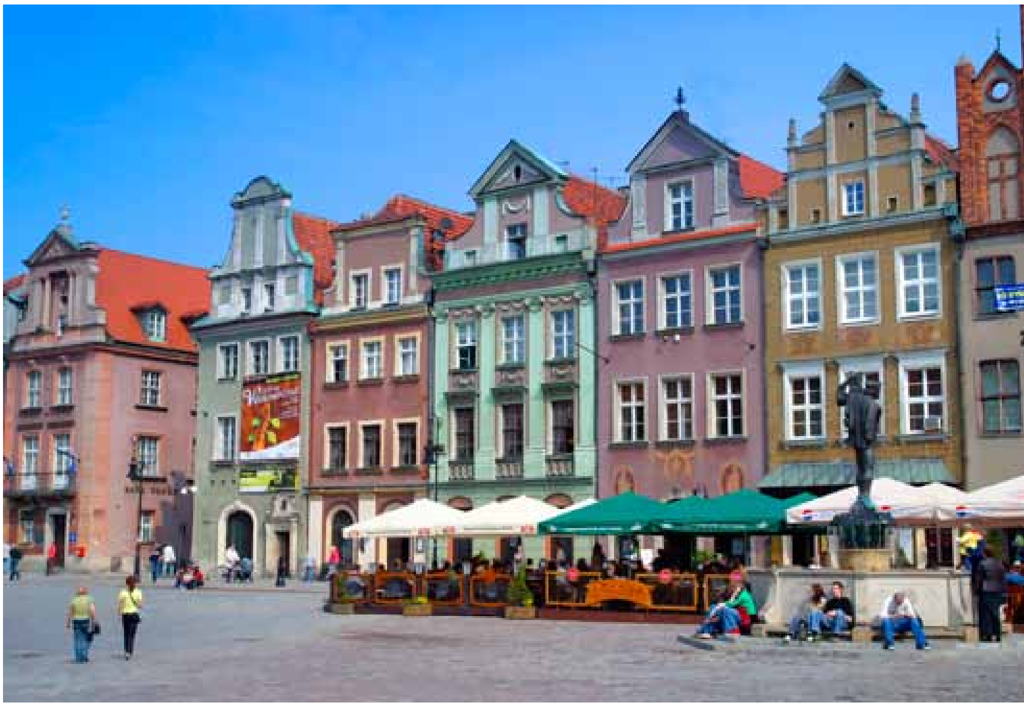
On another note, the Supreme Court of India has held that where a PE has been remunerated at an arm's length price capturing functions, assets and risks of the enterprise that created the PE, there can be no further attribution of profits to the PE.

Thus in determining what profits are to be attributed to an India PE, proactive approaches, sound transfer-pricing analysis, contractual agreements aligned with the business model and TP policy, and harmonised TP documentation could be an effective solution for PEs operating in India

TP & BUSINESS RESTRUCTURING

Keeping abreast of their global counterparts, the Indian TP authorities have taken note of the hot issue of how TP affects business restructuring. Those transactions popularly known as hive-offs involve dis-integration reflecting movement from a full-risk function to a lower-risk business; the implications of which are transfers of intangible property, exit-charge requirements and also the possibility of PE creation. The contention that risk and function are deeply entwined still holds good, and hence such transactions would call for robust documentation regarding the 'before' and 'after' situations. It is the 'substance over form' rule that would ultimately prevail. Since TP provisions cannot be overruled by simply interposing a third party, such a restructured business model necessitates an in-depth contract, functional, industry and economic analysis.

POLAND



The first transfer pricing regulations in Poland were introduced into the Polish Corporate Income Tax Act (hereinafter, the CIT Act) in 1992. Nowadays, Polish transfer pricing regulations concern on the one hand the obligation to prepare transfer pricing documentation and on the other hand the conditions and methods of estimation by the tax authorities of the market value of a transaction.

Under the CIT Act, taxpayers performing (a) transactions with related parties or (b) transactions in relation to which the payment of sums due as a result of such transactions is made directly or indirectly for the benefit of a person resident in, or having its seat or management located in, a jurisdiction deemed to be engaged in detrimental tax competition (a 'tax haven') must prepare transfer pricing documentation relating to those transactions.

De minimis exceptions apply in both cases. For related-party transactions, documentation need be prepared only where the total amount (or its equivalent) resulting from the contract or the total amount, actually paid in the tax year, in respect of performance enforceable in the tax year is greater than:

- EUR 100 000 if the value of the transaction does not exceed 20% of the initial capital
- EUR 30 000 where the transaction involves the provision of services, the sale of intangible fixed assets or making such assets available or
- EUR 50 000 otherwise

Where transactions with tax havens are concerned, the *de minimis* limit is EUR 20 000.

Generally, in the Polish transfer pricing regulations, the tax authorities are entitled to determine the taxpayer's income where, as between associated parties, there are agreed or imposed conditions substantially different from those that would be agreed between independent parties and, as a result thereof, the taxpayer either discloses no income or discloses an amount of income smaller than might be expected in the absence of the association.

The associations that bring the transfer pricing rules into play are as follows:

- where a taxpayer having its seat (or place of management) or residence in Poland, hereinafter referred to as a 'domestic party', participates directly or indirectly in managing or controlling an enterprise located abroad or has a share in its capital or
- where a natural or legal person resident or having its seat (or place of management) abroad, hereinafter referred to as a 'foreign party', participates directly or indirectly in managing or controlling a domestic party or has a share in its capital or
- the same legal persons or natural persons at the same time participate directly or indirectly in managing or controlling a domestic party and a foreign party or have shares in both parties' capital or
- a domestic party participates, whether directly or indirectly, in the management or control of another domestic party or holds a share in the capital of another domestic party or
- the same legal or natural persons participate at the same time, whether directly or indirectly, in the management or control of domestic parties or hold a share in their capital

Holding a share in the capital of another party means for these purposes a situation where one party, whether directly or indirectly, holds a share of at least 5% in another party's capital. While determining the size of an indirect share held by a party in another party's capital, the principle applies whereby if one party (A) holds a certain share in the capital of another party (B), and B holds the same share in the capital of a third party (C), then A holds an indirect share of the same size in the capital of C; if the sizes of these shareholdings (A's in B and B's in C) differ, A's indirect share in C is deemed to be of the smaller size.

In the case of domestic parties, the transfer pricing regulations also apply to links of a family nature or those resulting from employment relationships or property relations between domestic parties or persons performing managerial, inspectorial or supervisory duties with these parties or where any person combines managerial, supervisory or inspectorial duties performed with such parties. The family link means marriage and consanguinity or affinity (relationship by marriage) up to the second degree.

Incomes can be assessed by the tax authorities on the basis of estimation, applying the following methods:

- Comparable Uncontrolled Price
- Resale Price
- Reasonable Margin ('cost plus')

Only if application of the above methods is impossible, can the transactional-profit method be used.

If the tax authorities determine a taxpayer's income in an amount higher (or loss in an amount lower) than the amount declared by the taxpayer in relation to the transactions and the taxpayer does not produce to such authorities the tax documentation required by these provisions – the difference between the income declared by the taxpayer and that determined by the authorities can be subject to taxation at a rate of 50%.

The general rule in Poland is that when the taxpayer submits transfer pricing documentation at the request of the tax authorities, then even if the transaction price is adjudged to be not the arm's length price, the additional income is taxed at the general corporate tax rate of 19% and not at 50%.

It should be noted that, despite the existence of the TP regulations, the CIT Act nowhere contains a definition of 'transfer price'. The Act defines only the 'transaction price', as the price charged between the associated parties (whether or not it is the market price).

That being so, the taxpayer is obliged to prove in the transfer pricing documentation that the calculated price in the controlled transaction is such a transaction price. With reference to transfer pricing issues, the main problem for Polish taxpayers is the methodology of grouping transactions and valuing them to test against the de minimis limits described above, to see whether transfer pricing documentation is necessary.

PORTUGAL

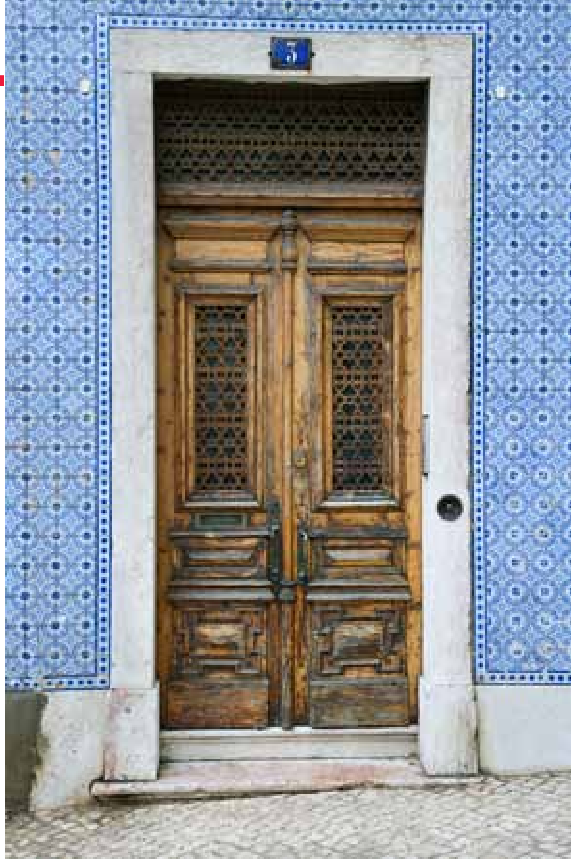
The Portuguese Corporate Income Tax (IRC) Code contains regulations on transfer pricing, based on OECD recommendations, together with the adoption of the arm's length principle.

The transfer pricing regulations, covering methods, issues related to documentation and corresponding adjustments, are contained in Ministerial Order № 1446-C/2001, of 21 December 2001.

Taxpayers with global net profits of more than EUR 3 million in the previous taxable period are required to keep duly organised on the tax file transfer pricing documentation as required by the Ministerial Order.

Since 1 January 2008, taxpayers have the possibility of concluding Advance Pricing Agreements (APAs) with the tax authorities, in order to determine the method that will be used to analyse operations under the transfer pricing provisions.

Taxpayers who are obliged to keep transfer pricing documentation but fail to do so are liable to a penalty of between EUR 500 and EUR 100 000.



SWEDEN

There is no domestic legislation or official procedure regarding Advance Pricing Agreements (APAs) in Sweden. Swedish taxpayers have therefore been forced to start a Mutual Agreement Procedure (MAP) with one or more countries with which Sweden has a tax treaty. Consequently, only bilateral corresponding adjustment procedures have been possible. Since the corresponding adjustment procedures have been regulated solely through tax treaties, there is currently considerable uncertainty as to how the Swedish tax authorities, taxpayers and the courts actually relate to the MAPs.

In October, the Swedish government proposed a formalised procedure for APAs. The rules regarding APAs will be regulated in a new tax Act, The Pricing Agreements in International Transactions Act. The purpose of legislating a procedure for APAs is to create a better predictability in complicated pricing issues as well as to avoid international double taxation. According to the proposal, the Swedish government is of the opinion that it is only through bilateral APAs that international double taxation can be avoided. Therefore, the proposed law covers bilateral agreements only.

According to the proposed law, APAs will not apply to questions that are of a simple nature or of a smaller scope. APAs will be given on application by a company that is or can be expected to become liable to income tax. Domestic as well as foreign companies with permanent establishments in Sweden will be covered by the Act and may apply for APAs.

The Act came into force on 1 January 2010. The Swedish tax authorities will be the competent authority when it comes to handling APAs and it is estimated that no more than 5-10 applications regarding APAs will be filed each year.

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