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TRANSFER PRICING NEWS

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INTRODUCTION

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BDO's Transfer Pricing Centre of Excellence continues providing information on the most recent developments in the area of transfer pricing. We are proud to present this 4th issue of *Transfer Pricing News*.

The transfer pricing area keeps on changing. Recently more and more tax authorities are focusing on business-restructuring issues, for instance transfer of functions and intangibles. You can find within a brief update on the new Australian and German developments related to business restructuring, on pages 2 and 3 respectively. Furthermore, Ireland has joined the growing list of countries having transfer pricing regulations. Will this mean the limitation of tax planning opportunities in Ireland? You can find out more in this newsletter. Finally, this newsletter provides updates on transfer pricing developments in some other countries. This 4th issue contains contributions from BDO Member Firms in Australia, Germany, India, Ireland, Israel, South Africa and Spain.

Prior to this year's BDO High Level Tax Conference, which will be held in **Madrid** (Spain), BDO will be organising a **client event on transfer pricing, to be held on Friday 22 October 2010**. The exact programme for this client seminar will be finalised shortly, and will focus on recent developments in the transfer pricing area. Invitations will be sent in September 2010.

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

AUSTRALIA

ATO RELEASES DRAFT RULING ON TRANSFER PRICING AND BUSINESS RESTRUCTURING

On 2 June 2010, the Australian Taxation Office (ATO) released Draft Taxation Ruling TR 2010/D2, setting out the ATO's preliminary views on the application of Australia's transfer pricing provisions to business-restructuring arrangements of multinational enterprises (MNEs) by which functions, assets and/or risks of a business are transferred between jurisdictions.

As business restructuring commonly involves the transfer of the ownership and management of intangible assets such as patents, trademarks and brand names, TR 2010/D2 notes that there is a need to determine the arm's length consideration payable and receivable in connection with a business restructuring in order to comply with the transfer pricing provisions.

PRINCIPLES TO CONSIDER IN DETERMINING THE ARM'S LENGTH CONSIDERATION FOR A BUSINESS RESTRUCTURING

In the context of transactions arising under a business restructuring, TR 2010/D2 notes that the arm's length consideration is determined by applying the most appropriate arm's length pricing method using available reliable data relating to an agreement between independent parties dealing at arm's length for a comparable transaction in comparable circumstances.

However, where there is insufficient reliable data on which to determine the arm's length pricing, TR 2010/D2 suggests the following principles should be considered in determining the consideration that might reasonably be expected to arise under an agreement between independent parties dealing at arm's length in comparable circumstances:

- An arm's length outcome is one that makes business sense in the circumstances of the particular taxpayer.
- An independent party dealing at arm's length would seek to protect its own economic interest.
- An independent party dealing at arm's length would compare the options realistically available and seek to maximise the overall value derived from its economic resources.
- An option might be not to enter into a transaction because it does not make commercial sense for the particular taxpayer.

OTHER OPTIONS REALISTICALLY AVAILABLE AT ARM'S LENGTH

It is important to note that in its guidance on determining the arm's length pricing associated with business restructuring, TR 2010/D2 places significant emphasis on evaluating whether there are options other than those presented under the business restructuring that are realistically available to the entity, and if so whether those alternatives would be more beneficial than the restructuring arrangement.

On this matter, TR 2010/D2 cites the OECD Transfer Pricing Guidelines, which state (at paragraph 1.15) "independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will enter into the transaction if they see no alternative that is clearly more attractive."

Thus, according to TR 2010/D2, an application of the arm's length principle in the context of business restructures suggests that an independent enterprise would not choose to participate in that particular business-restructuring arrangement if it would be worse off by doing so compared to pursuing other options that are realistically available to it.

In terms of influencing the pricing associated with business restructuring, the existence of other options that are realistically available will place the entity in a stronger bargaining position than an entity without other options. Accordingly, the Commissioner suggests in TR 2010/D2 that the existence of more beneficial options that are realistically available should be reflected in more favourable terms under the business-restructuring arrangement.

The availability of realistic alternatives is also relevant for testing whether the restructuring arrangement is comparable with other agreements between independent parties in similar circumstances.

BDO COMMENT

At first glance, the principles set out in TR 2010/D2 appear to be a straightforward application of the arm's length principle: that is, that the pricing associated with a business-restructuring arrangement should be consistent with that which would be expected under an agreement between independent parties dealing at arm's length in comparable circumstances. In other words, where a member of an MNE group transfers valuable assets (such as intellectual property rights, business contracts, licences or goodwill) to an overseas jurisdiction as part of a business-restructuring arrangement, that entity should receive appropriate consideration for the transfer of those assets, consistent with the arm's length principle.

However, the potential complexity arises in the requirement to consider whether the overall arrangement is one that makes commercial sense, and in particular to consider whether there are other options realistically open to the entity. This requirement potentially complicates the comparability analysis that would typically be undertaken in a conventional transfer pricing study, as the taxpayer will need to consider not only whether similar transactions undertaken by unrelated parties appear to be comparable, but also whether the comparability is impacted by the existence of other options realistically available to the entity involved in the business restructure.

TR 2010/D2 therefore presents a few surprises in the context of transfer pricing for business restructures, and taxpayers will need to be aware of how the commercial issues that uniquely impact upon their own economic interests should be reflected in the pricing associated with a business restructure.

GERMANY

CHANGE OF LAW CONCERNING THE CROSS-BORDER TRANSFER OF BUSINESS FUNCTIONS

The German transfer pricing rules for the cross-border transfer of business functions have been in place since 2008. The spirit and purpose of these rules is to tax the transferred profit potential including the value of the transferred intangibles. For this reason, the valuation of the transferred business function takes the so-called transfer-package valuation approach where the associated rewards and risks of the transferred assets as a whole are included. Valuation on an individual basis is exceptionally permitted if the taxpayer is able to demonstrate that no significant intangibles and advantages are transferred.

In March 2010, an amendment of the law took place. Although the prescribed transfer-package valuation has not been repealed and will continue to apply, a third escape clause has been added to the existing ones and comes into effect retroactively for the tax assessment period 2008. Now, the taxpayer is able to choose the valuation of transferred assets on an individual basis and thereby to exclude the goodwill elements of the transfer-package approach. This choice is available only if certain prerequisites are met: firstly, the taxpayer must demonstrate and credibly substantiate that at least one significant intangible asset is subject to the transfer of business functions and secondly, the affected intangible needs to be described in sufficient detail.

In our opinion, this change mitigates the taxation of capital gains regarding the cross-border transfer of business functions and in many cases will lead to the legal situation before the introduction of special rules in 2008, as it will be possible again to determine the arm's length transfer prices of the transferred assets on an individual basis. The obligatory use of the transfer-package valuation will be delimited to the transfer of functions where the taxpayer is **not** able credibly to substantiate that:

- no significant intangible asset is subject to the transfer of business functions; or
- at least one **significant** and **identifiable** intangible asset is subject to the transfer of business functions.

RECOMMENDATION

In the event of a cross-border transfer of functions, the tax adviser must examine whether the valuation of the transferred assets on an individual basis is more favourable to the taxpayer than the valuation of the transfer package. If the value of the transferred assets on an individual basis is more favourable, the taxpayer must credibly substantiate that either no significant or at least one significant intangible was transferred. If, however, the transfer-package valuation approach is more favourable, the taxpayer should choose this approach.

In our opinion, the valuation should be substantiated in transfer pricing documentation, which is now even more important after this change in the law.

INDIA

TRANSFER PRICING UPDATE

The way the life of a human child passes from infancy to maturity is similar to the transition of transfer pricing law in the context of Indian income tax. The year 2010 has so far seen a number of developments in the transfer pricing arena, with the pronouncement of a number of judicial decisions on the subject seeing a sharp plunge. Consequently, the rationale, concerning the core principles of TP such as the need for conducting a proper functional and risk (FAR) analysis, factors to be considered in the selection of the tested party as well as comparables, the types of adjustments to be made to the comparables when undertaking a benchmarking analysis etc, have been reiterated by the judicial authorities in India. These settled principles are further being rigorously followed, as a rule, by the lower tax authorities when carrying out transfer pricing audits.

'DATA ISSUED BY INDUSTRY BODIES' AND 'CUSTOMISATION OF PLI' HELD ACCEPTABLE FOR COMPARABILITY ANALYSIS[1]

In a welcome move by the tax authorities, in a specific case before the appellate tribunal, data published by the specific industry bodies (NASSCOM, in this case), have been treated as appropriate comparable data for the purpose of a benchmarking analysis of the companies operating in the same industry. Nevertheless, emphasis has adequately been laid on the detailed FAR analysis before accepting the data as comparable, since companies forming part of the same industry can also be 'functionally different', and accordingly their margins may differ materially. Hence, the comparable data of the specific segment to which the tested party belongs should only be reckoned as appropriate comparable data, and not otherwise. Another important aspect cited in the same ruling is that since transfer pricing is not an exact science that can be applied uniformly to all diverse situations, the Profit Level Indicator (PLI) must be selected after giving due cognisance to the fact and circumstances of each case. Thus, in the case of companies in their start-up phase, in order to obviate the effect of the initial capital costs, profit before depreciation has been considered as a preferred PLI in the benchmarking analysis.

ADJUSTMENTS FOR DIFFERENCE IN ECONOMIC AND MARKET CONDITIONS OF DIFFERENT COUNTRIES -MANDATORY[2]

In another judgment pronounced at the appellate level, the moot point of deliberations has been the adjustments to be made to the uncontrolled prices to render them comparable to the controlled prices of the tested party. This ruling has asserted that the mere presence of geographical congruity between the two nations cannot obviate the need for mandatory adjustments to eliminate the differences in economic and other market disparities between the two countries. Hence in a way, this judgment reiterates the fundamental principle of comparing like with like, which has also been emphasised in the OECD and the US transfer pricing guidelines.

Such assertions with reference to the fundamental principles would hopefully instil stability and tranquillity in the transfer pricing régime in this ever-evolving environment of tax laws in India.

[1] *DCIT v. M/s. 3 Global Services Pvt. Ltd. (ITA No. 1812 / MUM/ 2009)*

[2] *M/s Intervet India Private Limited (2010-TII-12-ITAT-MUM-TP)*

IRELAND

IRELAND HAS JOINED THE TRANSFER PRICING RACE!

Earlier this year, the Irish Government introduced transfer pricing legislation endorsing the OECD Transfer Pricing Guidelines for Multinationals and Enterprises and Tax Administrations and the arm's length principle. Ireland's introduction of transfer pricing legislation was widely anticipated and brings the Irish tax régime into line with international norms in this area. The new régime will apply to domestic and international related-party arrangements.

The background to the introduction of Irish transfer pricing legislation is probably the number of transfer pricing adjustments raised by foreign tax authorities involving multinational groups with Irish operations, and the increased protectionism of tax authorities throughout the world.

It does not appear to be designed as a revenue-raising measure. Rather, it may be viewed as a defensive measure intended to provide the Irish Revenue Commissioners with shiny new armour to defend the Irish tax base, while reassuring foreign tax authorities that Ireland is aligned with the international norm on transfer pricing.

There will be little change for most multinational groups with operations in Ireland as they have had to defend their transfer prices from foreign revenue authorities and the introduction of transfer pricing in Ireland does not fundamentally alter this position.

The new régime includes many features expected of a jurisdiction introducing transfer pricing for the first time, but the new legislation has two unique features that make it stand out from the international stage. The key features are:

– The new régime is confined to related-party dealings that are trading transactions (i.e. activities taxed at the 12.5% tax rate);

– The rules contain generous 'grandfather' provisions whereby arrangements entered into between related parties prior to 1 July 2010 are excluded from the transfer pricing rules.

The rules come into force from 1 January 2011 for all arrangements agreed on or after 1 July 2010.

They will only apply to large companies and to trading operations involving the supply and acquisition of goods, services, money or intangible assets. Income from passive activities such as rents, royalties and interest is excluded where such income is taxed at the 25% corporate tax rate.

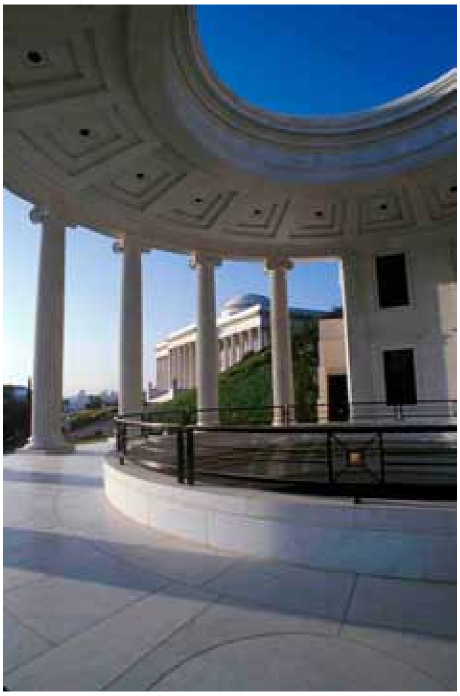
For most cases of interest-free inter-company loans, the new rules should not apply. The measures provide for an upward adjustment where sales are understated or expenses overstated in transactions between associated entities.

The rules do not apply to small or medium-sized companies. The cut-off point is where there are fewer than 250 employees and either turnover is less than EUR 50 million or assets are less than EUR 43 million. Documentation will be required and must be prepared on a timely basis.

These measures are seen as broadly positive from an Irish viewpoint. They should give support to multinationals with Irish operations and to the Irish Revenue authorities in defending requests for transfer pricing adjustments that they consider to lie outside the normal OECD guidelines. Far from deterring multinationals for whom transfer pricing is a permanent and necessary business consideration, this new régime should enhance Ireland's suitability as a location for international business.

ISRAEL

THE STATE OF ISRAEL JOINS THE OECD - TRANSFER PRICING IMPLICATIONS



Recently, the Secretary-General of the OECD (Organisation for Economic Cooperation and Development) announced that the Organisation's Governing Council, representing member economies, had admitted Israel as a full member in the OECD. The decision was made unanimously by all 31 members.

One of the implications of Israel's accession to the OECD is that Israel will be required to meet OECD standards as an assisting tool for activities in the international markets.

Inter alia, it is important to mention that Israel's tax treaties for the prevention of double taxation are already loosely based on the OECD Model Tax Convention on income and capital.

In November 2006, the Israeli Transfer Pricing Regulations, whereby every taxpayer in Israel has to comply with transfer pricing regulations regarding inter-company transactions between related entities, were enacted. The Transfer Pricing Regulations are based on the concepts embodied in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Currently, in the fourth year of implementation of the Israeli Transfer Pricing Regulations, there is no question that the tax authorities, as well as the taxpayer, will have to implement transfer pricing practice according to the practical methodology mentioned in the latest transfer pricing reports of the OECD.

SOUTH AFRICA

HOW DOES THE DOWNTURN IN THE ECONOMY IN SOUTH AFRICA IMPACT MULTINATIONAL ENTERPRISES?

South Africa felt a sharp decline in economic growth in 2008. Economic activity was adversely affected by severe electricity shortages, a slowing-down of consumption and the worsening world recession. Growth further weakened in 2009 and had a negative impact on the financial position of South African companies across a wide range of industries. South African companies have experienced and are currently experiencing losses and reduced profit margins as a result of the economic downturn. What does this mean for multinational enterprises? It becomes important now, more than ever, to adequately document transfer pricing to defend historical positions.

Transfer prices are prices that are set within a group between a South African company and an offshore group company for the transfer of goods and/or services. It would be imperative to demonstrate to the South African Revenue Service (SARS) that the resultant change in financial position is due to economic conditions and not 'non-arm's length' pricing i.e. pricing that is not market-related.

An example would be a Chinese parent company selling products to its South African subsidiary distribution company. The SA subsidiary is the simpler entity (has simpler functions and use of assets and assumes less risk) and as such is the tested party. In 2008 the SA subsidiary targets a distribution operating margin of 2% to 4% based on routine distribution companies' comparable data for 2005 to 2007. In the fourth quarter of 2008 the SA subsidiary's profits drop dramatically due to the economic downturn and it realises a loss. Numerous issues arise, one being that the results may not be apparent in time to adjust the transfer pricing for 2008. What should one do? Should one make a post-year adjustment to bring the SA company within the range? Amongst the issues to consider here is whether the parent company would accept the adjustment and the customs effect. The goal is to be able to demonstrate to SARS that the loss is due to the current economic conditions and not non-arm's length pricing. If this can be achieved successfully then the opportunity may exist not to make an adjustment .

A more global issue is the problem of trapped losses. An example to demonstrate is that of a limited-risk manufacturer set up in South Africa (SA Co). 'Limited risk' effectively means that SA Co bears minimal risk. The contract between SA Co and its offshore parent holding company and the nature of the business of SA Co by virtue of its limited risks (and limited functionality and assets) will guarantee a certain level of profit to SA Co irrespective of economic conditions in South Africa. When the business is profitable this structure would serve to optimise that taxpayer's global position by minimising profits taxed in South Africa (South Africa being the higher tax jurisdiction in the

group structure). In 2008 the parent suffers a consolidated loss as a result of the economic downturn. Notwithstanding that the company overall is lossmaking, the parent is required to allocate some profit to SA Co and pay tax in South Africa. The transfer pricing must follow the contractual allocation of risk and as such the contract shields SA Co from the risk of business downturns. The parent company carries the risk and as such should bear the corresponding losses associated therewith. The dilemma is that on a consolidated basis the parent is paying tax even though it has no income. The global understanding is that tax administrations are sceptical about loss sharing.

We foresee a lot more transfer pricing disputes raised by the SARS as a result of inadequate support for current intercompany pricing. Transfer pricing policies commonly used in a stable economy may need to be adjusted to account for the impact on taxpayers in a recession. Taxpayers need to be proactive in identifying factors whether they are economic, commercial or business factors that are contributing to their poor financial positions and document them. Any changes to existing business models as a result of the economic downturn would have an impact on existing transfer pricing policies. These changes would need to be reflected in current transfer pricing policies/documentation.

NO TRANSFER PRICING RULES FOR LOCAL SOUTH-AFRICAN COMPANIES

There was some debate after the Budget speech of the Minister of Finance as to whether the budget proposal was attempting to introduce domestic transfer pricing rules, i.e. to address intercompany transactions between SA local companies. This would have been a giant leap forward for revenue collection as the erosion of the tax base that applies to misallocation of profit domestically is as problematic as cross-border misallocation.

In terms of the Draft Tax Laws Second Amendment Bill 2010 and the Explanatory Memorandum relating thereto, domestic intercompany transactions will not be covered by the transfer pricing legislation contained in Section 31. The legislation will remain unchanged in applying only to cross-border intercompany transactions. The wording of the section will be amended to be more in alignment with that contained in double tax agreements. The current focus on goods and services will be revised and the focus will instead be on transactions, operations and schemes that have been effected or undertaken for the benefit of cross-border connected persons.

SPAIN

TRANSFER PRICING IN SPAIN

In Spain, transfer pricing regulations have existed since the late 1970s. The initial rules only allowed the tax administration to adjust transfer prices to arm's length prices in case of deviations that had actually resulted in lower taxes or deferred taxes in Spain. However, the legislation provided little inspection and other procedural support to the authorities to verify the prices, basically due to the lack of documentation requirements.

On 29 November 2006, the Spanish transfer pricing landscape changed dramatically as a result of Law 36/2006, 'Law on Measures for the Prevention of Fiscal Fraud', which, inter alia, introduced the direct obligation for taxpayers to apply arm's length prices in intra-group transactions, both in domestic and in non-domestic transactions. The new Law, which amended the Corporate Income Tax Act, also provided for far-reaching documentation obligations for the Spanish taxpayer, subject to a rigorous specific transfer pricing penalty régime.

Although initially envisaged for implementation in early 2007, the Spanish Corporate Income Tax Regulations (CIT Regulations) containing the specific documentation provisions were only modified on 18 November 2009. This created the unusual situation in which, during a period of more than two years (2007 and 2008), taxpayers were formally required to apply arm's length prices and to prepare transfer pricing documentation, without actually knowing the content and format of the documentation.

The modified Regulations finally entered into force on 19 February 2009, creating the obligation for taxpayers to prepare transfer pricing documentation for qualifying transactions as of that date. Some transactions, the most important being those carried out within the same fiscal unity, are excluded from these obligations.

There is no requirement actually to file the transfer pricing documentation with the tax authorities. The documentation must, however, be available for inspection as of the final day of the filing period of the annual Corporate Income Tax Return. For fiscal year 2009, this is 25 July 2010.

Following the spirit of the Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in The European Union, adopted by the Council of the European Union in June 2006, the Spanish CIT Regulations state that the taxpayer must prepare both a master file ('Documentation relating to the group of the taxpayer') and a taxpayer file. The focus of the documentation is nevertheless merely domestic, that is, the taxpayer must only provide information that is considered relevant to the Spanish tax authorities. The group documentation therefore does not entirely fit into the definition of the EU master-file concept, because it may not provide sufficient information on non-Spanish group companies and, therefore, it generally cannot be used by other group members to meet their local TP documentation compliance needs.

The CIT Regulations specifically define the elements of information that must be present in each of the transfer pricing files. Partial or non-compliance will be subject to penalties. Any missing, inaccurate or incorrect data item or collection of data items may be fined. The amount of the penalty will depend on whether an adjustment is made by the tax administration. The following two cases may apply:

– If there is no adjustment, there will be a penalty of EUR 1500 for each missing, inaccurate or false data item, or EUR 15 000 for a collection of missing, inaccurate or false data items.

– If there is an adjustment, the penalty will amount to 15% of the adjusted taxable base, with a minimum of double the penalty that would apply without an adjustment.

Finally, and in addition to the general transfer pricing documentation requirements, it is worth mentioning that, as of fiscal year 2009, taxpayers are also required to provide specific details on related-party transactions in the annual tax return. These details include the type of transaction, the identification of counterparties, amounts, and the transfer pricing method applied. For fiscal year 2009 only those transactions performed after 18 February 2009 must be communicated. The tax return is due no later than 25 July 2010.

The information to be provided in the tax return must be consistent with the contemporaneous transfer pricing documentation. It is therefore advisable to prepare the transfer pricing documentation prior to filing the tax return.

LIST OF CONTACT PERSONS

Hendrik Swaneveld International Tax Department BDO Toronto	Tel: Fax: E-Mail:	+1 416 865 0200 +1 416 865 0887 hswaneveld@bdo.ca
Dr Gerhard Engler International Tax Department BDO Frankfurt am Main	Tel: Fax: E-Mail:	+49 69 95 941235 +49 69 95 941326 gerhard.engler@bdo.de
Anton Hume International Tax Department BDO London	Tel: Fax: E-Mail:	+44 207 486 5888 +44 207 487 3686 anton.hume@bdo.co.uk
Jay Lee International Tax Department BDO New York	Tel: Fax: E-Mail:	+1 212 885 7226 +1 212 697 1299 Jlee2@bdo.com
Norbert Rosmalen International Tax Department BDO Rotterdam	Tel: Fax: E-Mail:	+ 31 10 242 4600 + 31 10 242 4624 norbert.rosmalen@bdo.nl