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INTRODUCTION

Transfer pricing is a very important topic on the tax agenda of many multinational enterprises. The topic is of interest not only to taxpayers but also to tax legislators in many countries, and the OECD.

This 7th issue of BDO's Transfer Pricing Newsletter focuses on recent developments in the field of transfer pricing in Australia, Canada, Malaysia, New Zealand and Russia. It follows that paying sufficient attention to transfer pricing is getting more and more important in order to comply with local transfer pricing requirements.

Business restructuring is a very interesting topic that entails transfer pricing as well as other tax and business related decisions. You will find an interesting contribution about the transfer pricing aspects of business restructuring in this issue of BDO's Transfer Pricing Newsletter.

As there is a constant and increasing demand for transfer pricing engagements to be run properly, BDO's Transfer Pricing Centre of Excellence is very pleased that the transfer pricing teams in many countries keep growing. An experienced team of transfer pricing advisors is key to a further development of BDO's global transfer pricing capabilities.

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AUSTRALIA

COMMISSIONER UNSUCCESSFUL IN SNF CASE APPEAL

In an important decision (*FCT v SNF (Australia) Pty Ltd* [2011] FCAFC 74) the Full Court of the Federal Court of Australia (Federal Court)has upheld the decision of a single judge of that court, Middleton J, in favour of the taxpayer, in *SNF (Australia) Pty Ltd v FCT* [2011] FCA 635.

The decision addresses, in the context of the application of the Australian transfer pricing rules (in Division 13 of Part III of the Income Tax Assessment Act 1936), amongst other things, the:

- appropriate method of determining an arm's length price;
- characteristics of the taxpayer that are relevant to such determination;
- identification of the appropriate market for such determination;
- burden of proof that must be satisfied by a taxpayer in order to challenge an assessment by the Commissioner of Taxation (Commissioner);
- relevance of the OECD *Transfer Pricing Guidelines for Multinational Enterprises* (OECD Guidelines); and
- relevance of the decisions of the Federal Court of Canada in *GlaxosmithKline Inc V The Queen* [2010] FCA 201 and *R v General Electric Capital Canada Inc* [2010] FCA 344 and of the UK Special Commissioners in *DSG Retail Limited v Commissioners for her Majesty's Revenue and Customs* (2009) UKFTT 31 (TC) 1.

The case is also of particular significance because it represents the first consideration of the substantive Australian transfer pricing provisions by the Full Federal Court.

Facts and issues

The case addressed an attempt, by the Commissioner, to apply the transfer pricing rules to reduce deductions allowed to the taxpayer in respect of the purchase price it paid to non-resident members of the SNF Group, for polyacrylamides (the Product), an industrial chemical used principally in the cleansing of water. In this regard, the SNF Group was a French based multinational conglomerate that manufactured and distributed the Product. The taxpayer was the Australian distributer of the Product.

It was notable that during the income years in question, the taxpayer had consistently made losses (and perhaps this is what captured the particular interest of the Commissioner). The cause of such losses was, however, in dispute. The Commissioner asserted that a material contributor to such losses was the payment, by the taxpayer, of excessive prices for the Product supplied to it. The taxpayer asserted that the prices paid by it were at, or below, arm's length prices, and the losses arose from other causes; in particular, unreasonably low sales per salesperson, competition in the Australian market, excessive stock levels and poor management.

The parties to the action were in agreement that:

- the transfer pricing provisions would be engaged only if the prices paid by the taxpayer to the suppliers exceeded the consideration which might reasonably be expected to have been paid if the transactions had occurred "between independent parties dealing at arm's length" (see s136AD(3)(c) and s136AA of the ITAA 1936); and
- it was the taxpayer who bore the onus of proving that the consideration paid did not exceed such arm's length amount.

There was a fundamental disagreement, however, as to the requirements imported by the 'arm's length' test. The taxpayer sought to rely on a comparable uncontrolled price (CUP) approach and, to this end, tendered evidence showing that the prices paid by the taxpayer were no greater than those paid to members of the SNF group by independent third parties (mostly in non-Australian jurisdictions) who, like the taxpayer, were distributors, of the Product (after appropriate adjustments were made for variables such as the currency specified in the contract and the terms of supply).

The Commissioner argued that the arm's length test required that consideration be only given to comparable transactions in which the purchasers shared each and every quality of the taxpayer bearing on price, save for it being under the control of SNF France, including a similar history of losses. On this basis, the Commissioner:

- asserted that CUP was unavailable as there were no such direct comparables;
- relied upon s136AD(4) of the ITAA 1936 which, "in circumstances where it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in respect of...[an] acquisition" deems the consideration to be "such amount as the Commissioner determines"; and
- argued for the adoption of a Transactional Net Margin Method (TNMM) to determine the arm's length price.

Underpinning the Commissioner's approach also appeared to be the contention that, to the extent that the taxpayer's losses arose as part of a 'market penetration' strategy by the SNF Group, these costs should not be borne by the taxpayer, but instead passed up the chain to the suppliers of the Taxpayer.

Court's Judgment

In dismissing the Commissioner's appeal, the Full Federal Court held that:

1. While some of the evidence admitted by the Judge at first instance should not have been admitted, there was still sufficient admissible evidence to uphold that Judge's decision.
2. To the extent that CUP could be used, it was preferable and the Commissioner had failed to establish that CUP was unavailable in respect of the transactions participated in by the taxpayer.
3. The evidence demonstrated that there was a global market for the Product, thus prices paid in different geographic locations could be used as comparables for sales into the Australian market, provided appropriate adjustments were made for any variables.
4. It did not matter that "prices actually paid might well fluctuate as between the comparable purchasers, reflecting their respective buying strengths and individual negotiating postures". The evidence was not about the existence of a single global price but, instead, about the existence of a global market.
5. Because the existence of an extensive range of comparables had been established, the premise upon which the Commissioner's use of TNMM rested was not made good and any use of TNMM was thus incorrect.
6. The arm's length test was not overlaid by a further requirement that the "arm in question be the arm of the taxpayer" and that such an approach is deeply impractical in nature and refuses to admit the possibility of making adjustments for differences in comparables.
7. The OECD Guidelines, which the Commissioner had sought to rely on to justify his approach, explicitly recognised degrees of comparability and the making of "reasonably accurate adjustments… to eliminate the effect of differences"
8. In any event, the OECD Guidelines were not a legitimate aid in the construction of the domestic transfer pricing provisions or the 'associated enterprises' articles of the applicable double tax agreements, as there was no evidence that any of the States in question had adopted the practice of applying such guidelines in relevant circumstances.
9. The decision of the UK Special Commissioners in the *DSG Retail* case provided support for the Full Federal Court's approach, as the Special Commissioners explained that "when there were material differences between the taxpayer and any proposed comparable, such differences should, where possible, result in adjustments and not exclusion of the comparable".
10. Neither of the Canadian decisions in the GlaxosmithKline nor General Electric Capital Canada cases was of assistance, because the text of the applicable Canadian provision (s69(2) of the *Income Tax Act* RSC 1985, c 1 (5^{th} supp)) was materially different in referring to "the amount ... that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length".
11. Notwithstanding the Commissioner's reliance on s136AD(4) of the ITAA 1936, in order to show that the Commissioner's assessment was excessive, it was not necessary for the taxpayer to show that the arm's length consideration was both a single ascertainable amount and less than the amount deemed by the Commissioner. Instead, it was only necessary that the taxpayer prove that it paid less than an arm's length price, which the taxpayer did here by proving that the prices it paid were less than those paid by comparable arm's length purchasers.

BUSINESS RESTRUCTURINGS

BUSINESS RESTRUCTURINGS REMAIN A HOT TAX ENQUIRY ISSUE

Since the publication of the updated OECD Guidelines on 22 July 2010, many companies have faced tax enquiry challenges for business restructurings they had made for sound business reasons. Many have asked themselves whether tax authorities were stepping in their shoes and judging with hindsight the decisions they made in the past. How come?

Background

The OECD has definitely lifted the bar for proving the arm's length nature of a business restructuring. The concept was also defined in a broad way so that many more cases are captured nowadays.

According to the OECD a business restructuring is defined as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-border transfers of valuable intangibles, although this is not always the case. It may also involve the termination or substantial renegotiation of existing arrangements (e.g. the conversion from a full risk distributor to a limited risk distributor).

A lot of attention was paid to business restructurings by the OECD and many tax authorities around the globe, as they were seen as a way to lower the tax burden in high tax countries and optimise the effective tax rate by shifting profits to low tax jurisdictions such as Switzerland or Ireland.

In order to demonstrate that a business restructuring is at arm's length, a company should not only support the arm's length nature of the transfer pricing arrangements before and after the restructuring; it should also support the arm's length nature of the restructuring itself. In order to do so, it can review the restructuring transactions and the functions, assets and risks before and after the restructuring, the business reasons for and the expected benefits from the restructuring, including the role of synergies, and finally the options realistically available to the parties involved in the restructurings.

We provide below some real life examples of tax enquiries we have recently experienced.

Example 1

A company decided to merge the back office of a sales organisation active in Belgium and the Netherlands to streamline its operations. Some people were relocated; others were laid off as they did not agree to move to the new central location in the Netherlands. As the company felt responsible for the laid off people, a generous leave package was paid. In its enquiries a number of years later, the Belgian tax authority questioned whether any compensation was due to the Belgian entity, as it considered that the Dutch entity benefited more from the restructuring than its Belgian counterpart. In particular it felt that the layoff costs, including the generous package, were too high compared to the overall benefit for the entity. The Belgian tax authorities also referred to the comments provided in the Guidelines on outsourcing arrangements. They seem to illustrate that in some outsourcing arrangements a compensation is paid between parties. This example demonstrates that a sound business restructuring, especially from a group perspective, could still be challenged. We had to demonstrate that in the long term the benefits would outweigh the costs, even on a Belgian level. To do so, we used documentation that was created at the time of the transaction, which was not specifically drawn up for tax purposes (e.g. presentations to the management team and personnel).

Example 2

Another example is that of a Canadian group selling branded fast moving consumer goods that grew significantly across Europe through a combination of organic growth and some acquisitions. In particular, it acquired production plants in various countries. At one point in time, the group was faced with a structural capacity issue in the market. It reviewed its footprint and decided to close one plant in the Netherlands. Production was shifted subsequently to another plant in the Netherlands and one in France. In this case, the Dutch tax authorities challenged the transfer pricing arrangements before the restructuring (a cost-plus approach was applied for the tolling activities of the plant) and the deductibility of the restructuring costs. We demonstrated with a CUP analysis, making reference to tolling activities performed for third parties as private label supplier, that the cost-plus was both in terms of method and in terms of mark-up acceptable. Further, we demonstrated that along the group's history each and every location had to bear its own restructuring cost. In addition, most of the production was shifted to another Dutch plant. Finally, one could question what the most realistic option was for the plant on a standalone basis. Most likely, it did not make any business sense to invest heavily in the plant to improve its productivity, knowing that already a structural capacity issue existed in the market.

Example 3

Finally, we touch upon the change in transfer pricing method that was agreed between a French distributor and its related company in the Netherlands. In the past, products were sold from the Netherlands to France on a cost-plus basis. Significant losses were incurred in France over a long period of time (more than ten years). The new system would provide the distributor with a guaranteed net margin that would be slightly increased or decreased, taking into account the performance of the French entity. In their enquiries, the French tax authorities made their own benchmarking analysis to test the arm's length nature of the transfer pricing arrangements and challenged the recurring loss position. They did not in particular question the change in transfer pricing policy as such; also the question whether something of value was transferred upon conversion was not put forward. Nevertheless some adjustment had to be accepted, even when it was demonstrated that a large portion of the losses had to be attributed to an expensive flagship store in downtown Paris.

Conclusion

The above are just a few examples that could be challenged by the tax authorities upon restructuring of a group's value chain. Even though tax aspects are not driving the decision to restructure, a company should be prepared to deal with a challenge a few years later. Contemporaneous documentation that is created for non-tax purposes will play a crucial role. However, a prudent business manager would also document the analysis from a transfer pricing perspective.

CANADA

COURT UPHOLDS CUP AS THE PREFERRED TRANSFER PRICING METHOD

Alberta Printed Circuits Ltd. ('APC Canada') v. The Queen (the 'Alberta case') was a recent transfer pricing court case in Canada that was closely followed due to its implications for the selection and application of transfer pricing methodologies, particularly the comparable uncontrolled price ('CUP') method, and on the identification of internal and external comparable transactions in the application of the CUP[1].

Transfer pricing policy background

The foremost guiding framework for determining the arm's-length nature of cross-border transactions between related parties is the OECD Transfer Pricing Guidelines ('OECD Guidelines'). Canadian transfer pricing legislation and administrative policy ('TP rules') closely rely on the OECD Guidelines, particularly in providing guidance to taxpayers on selecting the most appropriate transfer pricing methodology to support the arm's length nature of their transactions with non-resident related parties. The OECD Guidelines and Canadian TP rules have consistently expressed a preference for traditional transaction methods to compare the transactions between related parties with similar transactions between unrelated parties. The CUP method is preferred over the other traditional transaction methods, and over the transactional profit methods. Canadian TP rules acknowledge an implicit hierarchy of transfer pricing methods with the CUP as the highest method. Canadian taxpayers are required to apply the CUP or provide sufficient reasoning why it is not appropriate to do so before proceeding to select lower-ranked methods.

Case background

APC Canada manufactured custom prototype circuit boards used by circuit board designers, when it started operations in 1984. As part of the pre-manufacturing process, APC Canada received data from customers which it used to prepare a mock design (activities called 'set-up') that was used for manufacturing the actual circuit board. Years later, the set-up activities and some additional functions were moved offshore to a related company in Barbados. APCI, Inc. ('APC Barbados') was controlled by one of the original founders of APC Canada. Because the set-up process had become automated, APC Barbados was able to receive data electronically through its servers, perform the set-up process and then send the file to APC Canada. APC Canada then manufactured the prototype circuit board.

For its services APC Canada compensated APC Barbados with set-up fees, and non-set-up bonus 'square-inch' fees. The square-inch fees were for other services (e.g. website maintenance) performed by APC Barbados. APC Canada charged its third party customers fees that were split between set-up services and the actual manufacture of the prototype circuit boards. The fees for set-up services charged to third party customers were identical to the fees charged by APC Barbados to APC Canada[2].

The Canada Revenue Agency ('CRA') disagreed with the fees and disallowed approximately CAD 3.6 million in total fees paid during 1999-2001.

Tax Authority's position

The CRA took the position that APC Canada should have used the transactional net margin method ('TNMM'), a less-preferred method, to determine a mark-up for the services provided by APC Barbados. The CRA dismissed APC Canada's application of the CUP, as well as the comparables presented by APC Canada, by arguing that the set-up services were an integral part of the manufacturing process and not a separate identifiable service and, therefore, the set-up service fees had to remain bundled with the fees for manufacturing services.

Taxpayer's position

APC Canada argued that the fees paid to APC Barbados were similar to those charged to its third party customers who pay separately for set-up services and the manufacturing services, and that these services and the related fees should be unbundled. Thus, APC Canada argued that the pricing is based on the CUP method, given that the related party transactions can be compared with the comparable transactions with third party customers ('internal CUP'). APC Canada was also able to identify similarly structured transactions between third parties ('external CUPs').

Court decision[3]

The Tax Court of Canada ('TCC') found that the fee for set-up services could, and should, be unbundled from the fee for manufacturing services. The TCC agreed that the set-up fees charged by APC Barbados to APC Canada were comparable to the fees charged by APC Canada to its third party customers. The TCC also accepted the external comparables offered by APC Canada. The TCC chastised the CRA for rejecting APC Canada's use of the CUP without sufficient reasoning, and for ignoring the comparables APC Canada offered as evidence.

However, the TCC did not agree with the taxpayer with respect to the non-set-up fees, since the onus was on APC Canada to demonstrate that it did not overpay for the non-set-up services. APC Canada failed to support the pricing for the non-set-up fees. Consequently, the TCC reduced the adjustment from approximately CAD 3.6 million to only approximately CAD 0.88 million.

Implications

– ***Renewed focus on CUP***
  The decision in the Alberta case has put renewed focus on the use of the CUP as the preferred method over all other transfer pricing methods. From a Canadian transfer pricing perspective, the decision stresses to taxpayers the importance of identifying internal and external comparable transactions, difficult as it may be, and determining how to make any required adjustments to those comparables to use the CUP method.

– ***Onus on both tax authorities and taxpayer to determine appropriateness of the CUP***
  This also puts the onus equally on both the taxpayer as well as tax authorities to provide compelling reasons to dismiss the use of the CUP method before proceeding to select lower-ranked methods in proving the arm's length nature of the cross-border related party transactions.

– ***Existence of comparables cannot be simply ignored***
  An interesting aspect of the case arises from the fact that when internal or external comparables are identified, both the taxpayer and tax authorities are required to evaluate if they can be used as CUPs, and this may include determining if appropriate adjustments can be made to the comparables to increase their comparability with the related party transaction. This translates to additional work, initially to establish comparability, and then to perform the adjustments contemplated.

1. There were other legal issues touched on by the court decision on the Alberta case that this article will not cover.
2. The court finds that no mark-up was applied by APC Barbados for the set-up fees to APC Canada.
3. The OECD Guidelines and Canadian TP rules in effect during the assessment years 1999-2001 were considered by the court in its decision. Recent revisions to the OECD Guidelines which came into effect in 2010 were not considered.

MALAYSIA

DEVELOPMENTS IN TRANSFER PRICING

On 2 July 2003, the Malaysian Inland Revenue Board ('MIRB') issued the Transfer Pricing Guidelines ('TP Guidelines') to provide guidance to taxpayers in applying the arm's length standard. The TP Guidelines were largely based on the guidelines issued by the Organisation for Economic Co-operation and Development ('OECD').

With the introduction of the TP Guidelines, the MIRB also formally commenced its transfer pricing audits in 2004/2005, with its focus mainly on tangible goods, i.e. sales and purchases between related parties.

On 1 January 2009, in an effort to promote more clarity to taxpayers in their transfer pricing dealings and to increase the powers of the tax authorities, specific legislation was introduced in relation to Advance Pricing Arrangements, Pricing Adjustments and Thin Capitalisation under Sections 138C and 140A of the Malaysian Income Tax Act, 1967 ('the Act').

Advance Pricing Arrangements ('APA')

Section 138C of the Act provides taxpayers (which are engaged in cross border transactions with their associated parties) with an option to file an application with the MIRB to enter into an arrangement to determine an appropriate transfer pricing methodology to be used in their future dealings with their related parties.

The APA represents an agreement between the tax authority and taxpayer on the arm's length price of their international dealings with related parties for a particular period of time (generally 3 to 5 years in Malaysia's context). In addition, it also avoids disputes arising from transfer pricing audits which are both time-consuming and costly.

Applications for APA can be submitted using the following forms (revised on 31 March 2011):

(a) Revised Form APA 1 [Pin. 1/2011] for application of unilateral APA;

(b) Form APA 2 [2011] for application of bilateral APA.

The APA submission requires complete supporting documentation in relation to the following:

- Group and shareholding structure;
- Information on the applicant's business, industry environment, industry and market analysis and details of competition;
- Nature and scope of transactions covered;
- Transfer pricing methodology, critical assumptions and rationale;
- Transfer pricing documentation with respect to the covered transactions;
- Inter-company agreements; and
- Other relevant supporting documents.

Thin Capitalisation Rules

Section 140A(4) of the Act was introduced to address thin capitalisation in Malaysia. However, further detailed regulations are required for its implementation and for the rules to take effect. On 21 February 2011, it was announced that implementation of the Income Tax (Thin Capitalisation) Rules would be deferred to the end of December 2012.

Transfer pricing tracking mechanism

With the increased focus on transfer pricing audits and the quantum of adjustment involved, the MIRB appears to be tightening its monitoring and review activities on cross border transactions by Malaysian companies.

The MIRB has also over the years progressively intensified its focus on intangible transactions such as provision of services, intellectual property and licensing arrangements and more recently, on intercompany loans.

In this connection, the MIRB has in July 2011, issued a transfer pricing risk assessment form, i.e. '*Form MNE (1/2011) Information on Cross Border Transactions*', to selected taxpayers to collate more detailed information on cross border transactions, with a view to help taxpayers comply with the arm's length principle in related party transactions.

Form MNE (1/2011) Information on Cross Border Transactions

The following information is required to be disclosed in the Form MNE (1/2011):

- A chart of the entire global structure of the group of companies to which the taxpayer belongs and companies with which the taxpayer carries out related party transactions;
- Particulars of transactions with related companies outside Malaysia, including:
  - Stock in trade/raw materials
  - Other tangible assets
  - Royalties/licenses fees and other payments on use of intangible assets
  - Management fees including fees/charges for financial, administrative, marketing and training services
  - Research and development
  - Other services not falling under the above category
  - Rent/lease of assets
  - Interest
  - Guarantee fee
  - Others;
- Particulars of financial assistance with related companies outside Malaysia (distinguishing between interest bearing loans, interest bearing trade credit and interest free loans);
- Nature of taxpayer's business activity and its industry; and
- Whether transfer pricing documentation has been prepared by the taxpayer.

In view of the introduction of the above form and the development of the transfer pricing administration in Malaysia, more taxpayers are likely to be subject to transfer pricing audits by the tax authority. It is evident that the tax authority is increasing the responsibility of taxpayers on transfer pricing documentation, and is preparing the way for greater enforcement. It is therefore important for taxpayers to review internal policies and bases for their related party transactions, and ensure that there is sufficient transfer pricing documentation.

NEW ZEALAND

UPDATED ADMINISTRATIVE PRACTICE FOR SERVICES AND SMALL VALUE LOANS

New Zealand recently published an update to the Inland Revenue administrative practice on certain transfer pricing matters. The update forms an addendum to the transfer pricing guidelines previously issued by the New Zealand Inland Revenue in October 2000.

Arm's length principle

Under the Income Tax Act 2007 cross-border transactions with related parties for "the acquisition or supply of goods, services or anything else" must be at an arm's length consideration.

In determining the arm's length consideration taxpayers must apply whichever method or combination of methods produces the most reliable measure of the amount that completely independent parties would have agreed upon after real and fully adequate bargaining. The methods being:

1. Comparable uncontrolled price method (CUP method);
2. Resale price method;
3. Cost plus method;
4. Profit split method; and
5. Comparable profits method.

In choosing which method or combination of methods to use, taxpayers must have regard to the following factors:

- The degree of comparability between the uncontrolled transactions used for comparison with the controlled transactions;
- The completeness and accuracy of the data relied on;
- The reliability of all assumptions; and
- The sensitivity of a result to possible deficiencies in the data and assumptions.

To assist taxpayers in applying these methods and assessing the factors, the New Zealand Inland Revenue have issued a number of transfer pricing guidelines, including specific guidelines on the treatment of intangible property, the treatment of intra-group services, such as management fees, and cost contribution arrangements.

Relationship with OECD Guidelines

The New Zealand Inland Revenue Guidelines do not replace the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, but are intended to supplement the guidelines. The New Zealand Inland Revenue state that the OECD Guidelines will be the relevant guidelines to follow if, for example, a transfer pricing issue is raised under New Zealand's Double Tax Agreements.

The OECD Guidelines are endorsed by the Inland Revenue and therefore the New Zealand transfer pricing guidelines should be read as supplementing the OECD Guidelines, rather than superseding them. The New Zealand guidelines are an attempt to explain the OECD guidelines with a practical focus and in a way that is more accessible to New Zealand taxpayers, and can contain solutions to issues that are better suited to the New Zealand business environment.

The recent update of the New Zealand Inland Revenue administrative practices on services and low value loans are a good example of the philosophy behind the New Zealand guidelines in action.

Administrative practice for services

The New Zealand Inland Revenue do not as a general rule support the use of safe harbour thresholds, as they can result in prices being determined that are clearly inconsistent with the arm's length principle but are consistent with the safe harbour. An example of this may be an incidental service which if provided in-house has a cost which is in excess of a CUP for that service.

However the Inland Revenue is conscious of the desirability to minimise compliance costs for taxpayers, particularly where this can be achieved without compromising the integrity of the arm's length principle.

Accordingly the Inland Revenue will follow:

- an administrative practice applying to non-core services, being activities that are not integral to the profit earning or economically significant activities of the group; and
- an administrative practice applying to services where the costs of the services are below a de-minimis threshold applying to all intra-group services supplied or acquired where the relevant cost limit is not exceeded.

Non-core services

The administrative practice applying to non-core services does not apply to all intra-group services. There is a restriction where the total amount charged for the services is not more than 15% of the total accounting expenses or accounting revenues (depending if it is a supply that is being made or received) of the group, and adequate documentation is maintained by the taxpayer. Under these conditions an acceptable transfer price will be:

- not more than the lesser of:
  - the actual charge and
  - the cost of providing the service plus a 7.5% mark-up.

If the total direct and indirect cost of providing the services is not more than the de minimis threshold, then the administrative practice does not distinguish between core or non-core services.

Core services refer to an integral part of the profit earning or economically significant activities of the group. Previously, the administrative practice would apply when the total direct and indirect costs of supplying the services is not more than NZD 100,000 in a year. This has been increased to NZD 600,000 for services supplied between associated parties.

The increase is to align the administrative practice with the Australian Tax Office threshold and further minimise compliance costs between Australia and New Zealand, but it is not limited to services provided between those two countries.

Important limitation

The Inland Revenue make it clear that the administrative practice does not absolve taxpayers from the requirement to establish that a service or benefit has actually been supplied. If no service has been supplied or provided then no charge made would be at arm's length.

Taxpayers must maintain documentation to establish the nature of the services supplied or acquired and to address the issues (as far as is relevant) considered in calculating the relevant total costs.

Administrative practice for small value loans

The Inland Revenue have accepted since October 2009 in relation to small value loans, an interest rate of 300 basis points (3.0%) over the relevant base indicator (generally the bank bill rate for variable rate loans or the swap rate for fixed rate loans) as broadly indicative of an arm's length rate in the absence of a readily available market rate for a debt instrument with similar terms and risk characteristics.

The Inland Revenue has reconfirmed this rate with application of this safe harbor interest rate until mid-2012 and will apply for small value loans of up to NZD 2 million in principal outstanding (an increase from a previous increase of NZD 1 million).

Conclusion

The changes to the de minimis threshold for services and the safe harbor interest rates for small value loans are two practical steps endorsed by the Inland Revenue to reduce compliance costs for many small to medium size companies and are consistent with the philosophy of providing practical guidelines for taxpayers to follow.

RUSSIA

NEW PROVISIONS OF THE RUSSIAN TAX CODE WITH RESPECT TO TRANSFER PRICING

On 18 July 2011 the Russian President signed the Law #227-FZ "On introduction of changes to Russian legislation in connection with improving the principles for determining prices for tax purposes" (hereinafter – the 'Law'), which provides for new transfer pricing regulation. In particular, the new section VI 'Related parties. General provisions with respect to prices and taxation. Tax control with respect to transactions conducted by the related parties. Advance Pricing Agreement' is introduced into the Russian Tax Code (hereinafter – the 'Tax Code').

Implementation of the Law

The majority of the Law's provisions will come into force from 1 January 2012 (item 1 of article 4 of the Law). With respect to certain other rules of the Law, separate timeframes will apply, as described in the relevant sections below. Currently effective provisions of Articles 20 and 40 of the Tax Code should be applied to transactions under which taxpayers recognise income and (or) expenses in accordance with Chapter 25 of the Tax Code before the Law comes into force (item 6 of article 4 of the Law).

Controlled transactions

The list of controlled transactions has been changed.

The Law sets out the definitive list of transactions subject to transfer pricing control by the tax authorities:

– related party transactions (with certain limitations provided below);

– sets of transactions conducted via non-related persons which result in provision of goods (work, services) among related entities;

– cross-border transactions with goods traded on global commodity exchanges (oil and oil products, ferrous and non-ferrous metals, precious metals and stones); and

– transactions with a counterparty which is registered, resides is or is recognised as a tax resident of a jurisdiction included in a blacklist of jurisdictions published by the Russian Ministry of FInance (offshore jurisdictions). Such transactions include transactions conducted with permanent establishments of Russian organisations located in offshore jurisdictions, if these transactions are connected with activities of the permanent establishments.

Cross-border transactions mentioned in the last two points above are regarded as controlled transactions if the aggregate annual amount of income under such transactions with one counterparty exceeds RUB 60 million.

The Law establishes the following limitations to transfer pricing control with respect to transactions conducted in Russia by related parties:

– if the aggregate annual amount of income resulting from transactions between related parties exceeds: RUB 3 billion in 2012, RUB 2 billion in 2013, RUB 1 billion starting from 2014;

– if one of the parties pays unified tax on imputed income or unified agricultural tax (transaction is conducted within the activities subject to such tax regimes). The respective rule will be applied starting from 1 January 2014 to transactions where the volume exceeds RUB 100 million in a calendar year;

– if one of the parties is a payer of mineral extraction tax (MET) and the transaction involves operations with mineral resources subject to an ad valorem rate of MET;

– if one of the parties benefits from the profits tax exemption or pays profits tax at a 0% tax rate;

– if one of the parties is a resident of a special economic zone (starting from 1 January 2014) where certain profits or tax benefits are established.

The last three types of transactions are regarded as controlled transactions if the aggregate annual amount of income under such transactions exceeds RUB 60 million.

'Non-controlled' transactions

The following transactions which fall under the criteria of controlled transactions mentioned above are exempt from transfer pricing control:

– Transactions between members of a consolidated group of taxpayers (this rule could come into effect when the law with respect to consolidated groups of taxpayers is introduced and comes into force. At present, the draft of the respective law has been approved by the Russian State Duma on the first reading);

– Transactions with an annual value of more than RUB 1 billion (if there are no other grounds for the transaction to be controlled) which are conducted by parties in the following circumstances:

  – the parties are registered within the same region of Russia, none of the parties have separate subdivisions in other regions of Russia and outside Russia, and none of the parties pays profits tax to the budgets of other Russian regions

  – none of the parties has tax losses.

Related parties

The list of persons recognised as related parties is considerably extended. For the first time the Law defines the conditions under which organisations and individuals could be regarded as related.

One of the main criteria of recognising parties as related is still the direct or indirect ownership threshold; however, this is lifted to 25%.

In addition, two or more organisations, or an organisation and an individual, would be declared related parties, if:

– one person has more than a 25% direct or indirect participation in the equity of these organisations;

– one person has a right to appoint (elect) a sole executive body of the organisation, or more than 50% of the members of its collegial management body or of its board of directors/supervisory board;

– the same individuals comprise more than 50% of the members of the collegial management body or of the board of directors/supervisory board of the organisations;

– one individual acts as the sole executive body of the organisations;

– the share of the direct participation of each previous person (including an individual) in each next organisation is more than 50%.

As previously, individuals are recognised as related parties, if:

– such individuals are subordinated in terms of official position;

– individuals have a marital relationship or kinship (parents, children, blood or non-blood brothers and sisters, adoptive or adopted, trustee and persons in ward).

The Courts, or the counterparties themselves, can declare counterparties of a transaction to be related for other reasons than those defined in the Law.

Pricing under controlled transactions for tax purposes

Under the general rule, prices for transactions conducted by related parties are deemed to be the market prices whilst the reverse is not proved. This rule remains unchanged. The rule preserves the taxpayer's right to use a price, different from the actual price of the transaction, as a basis for the calculation of taxes, if the actual price does not correspond to the market level.

If the actual price in the transaction with the related party does not correspond to the market level, and if the respective inconsistency leads to an underpayment of taxes, the taxpayer has a right to make a price adjustment by itself after the end of a calendar year which includes the tax periods for which the respective taxes should be adjusted. Such adjustments should be made by the deadlines established for the submission of the annual profits tax returns (simultaneously with the submission of the tax returns). No late payment interest should be paid where the taxes were additionally accrued based on such an approach.

Comparable transactions

The Law contains a new detailed approach to the identification of comparable transactions. This approach implies a comprehensive analysis of the terms of transactions as well as functional and risk-analysis of the controlled transaction and the transaction treated as comparable.

Under the general rule the transaction could be regarded as comparable to the analysed transaction, if it is conducted by non-related parties in similar commercial and (or) financial conditions to the conditions of the analysed transaction. However, additional investigation should be undertaken with respect to the consistency of certain other factors influencing the transaction's execution. In particular, the consistency of the following factors should be verified:

– characteristics of the analysed and comparable transactions which could have a significant influence on their terms (quantity (volume) of supplied goods, work, services, timeframes of execution of obligations, etc.);

– functions performed by the parties to the transactions (for example, assembling and installation of equipment, etc.);

– number of risks carried by each party to the transaction under its execution;

– characteristics of markets where the goods (work, services) are supplied under the analysed and comparable transactions (location, competitive environment, etc.);

– commercial strategies of the parties under the analysed and comparable transactions, i.e. the parties' purposes of entry into the transaction.

Separate criteria are set out with respect to identification of comparable terms of loan, warranty and guarantee agreements.

Sources of information

Under the Law only publicly available sources of information may be used by both taxpayers and the tax authorities for the purposes of pricing analysis under controlled transactions.

The tax authorities are prohibited from using any information that could be classed as a tax secret, or when access to such information is restricted by the Russian legislation.

The permitted sources of information include information on Russian and foreign stock exchange prices and quotations, customs statistics, data from agencies providing pricing information, and information regarding the taxpayer's operations. If the above mentioned sources do not contain the necessary information, or if the available information is insufficient, the tax authorities have a right to use certain other sources which, however, also should be public. Such sources include data from financial statements and statistical reports of organisations, information on the market value of assets subject to valuation, and other sources. Therefore, the list of informational sources is open.

Transfer pricing methods

Transfer pricing methods are established for the purposes of tax control: the taxpayer is not obliged to follow such methods in its pricing decisions.

The Law stipulates that the tax authorities should determine market price based on five methods commonly used in international practice:

– Comparable uncontrolled price (CUP method);

– Resale-minus;

– Cost-plus;

– Comparable profitability;

– Profit-split.

The Law stipulates that the CUP method has priority. The other methods could be applied only if the first method is not applicable, or leads to biased results. In such cases the transfer pricing method, which could produce the most reasonable conclusion on the compliance of the price to the market level, taking in account actual circumstances and terms of the transaction, should be applied. The application of two or more of the methods is permitted; however, the priority of each method should be graduated depending on the subject and the terms of the transaction.

For example, in the case of resale of goods through a chain of related parties, the resale-minus method would be a primary tax control method. The cost-plus method is generally applicable for tax control purposes with respect to the provision of services.

The algorithm of implementation of each transfer pricing method is described in separate articles of the Tax Code. For instance, the CUP method implies that the actual price of a transaction should be compared with the range of market prices, which is calculated in accordance with a rather complicated algorithm. The range is determined based on prices of comparable transactions, including those conducted by the taxpayer. Therefore, information about at least one comparable transaction available in public sources of information is sufficient to apply the CUP method. In this regard, if the price of a controlled transaction falls within the range of market prices, the actual price is regarded as the market price for tax purposes. Otherwise, the minimum or maximum price of the range should be applied accordingly.

Transfer pricing documentation and reporting requirements

The Law expands taxpayers' liabilities with respect to reporting on tax issues. In particular, the taxpayer is obliged to provide documentation on certain transactions, or groups of similar transactions, to the tax authorities.

The Law does not envisage the form of the transfer pricing documentation. However, the respective documents should contain the following information:

– a description of the activities of the taxpayer which is a party to the transaction, as well as a list of other parties involved in the transaction;

– the subject and terms of the transaction (functional analysis of the transaction and its terms);

– a description of the transfer pricing method used to determine the market price of the transaction, reasons for the choice of the particular transfer pricing method, sources of information used, and calculation of the market prices range (profitability range);

– the financial result of the transaction and its profitability;

– other information.

These documents can be requested no earlier than 1 June of the year following the year when the controlled transaction took place. The documents should be provided by the taxpayer within thirty days of the request.

Documentation will not be required for transactions with securities, assets with regulated prices, and transactions covered by Advance Pricing Agreements (APA) concluded by the taxpayer and the tax authorities.

The documentation requirements are enacted gradually. Companies will be obliged to provide specific transfer pricing documentation in 2013, if the total amount of income of all controlled transactions with one counterparty received by the taxpayer in 2012 exceeds RUB 100 million. In the next year this volume will be reduced to RUB 80 million and thereafter these restrictions will not be applicable at all.

Moreover, taxpayers will occasionally be obliged to submit notifications to the tax authorities of controlled transactions conducted in a calendar year, with a description of the subject of the transaction, its parties and the amounts of income/losses received as a result of the transaction.

Namely, the taxpayer should include in the notification information about all transactions with each related party, if the amount of the income/losses received/incurred by the taxpayer from transactions with this party exceeds RUB 1 billion (in 2012 a limit of RUB 3 billion will be applicable). Taxpayers will be obliged to submit notifications on controlled transactions to the tax authorities no later than 20 May of the next year after the reporting year. At the taxpayer's discretion, the notification could be submitted in a hard copy or in electronic format. The Law provides for the right to submit revised notifications, if shortcomings are revealed (incomplete information, inconsistencies or mistakes).

Corresponding adjustments

The taxpayers cannot make corresponding adjustments autonomously.

One of the most significant innovations introduced by the Law, which does not have analogies in the Russian legislation, is connected with the rules on corresponding adjustments. These rules permit a collective adjustment of prices by all parties to the transaction for tax purposes. Corresponding adjustments will be possible only if the tax base of one party was adjusted by the tax authorities based on market price.

Corresponding adjustments can be made in relation to transactions conducted by two Russian taxpayers, and these will be applicable to profits tax and VAT liabilities. In this regard, adjustments can be made only in a permitted order, and only when the taxpayer, whose transactions were challenged by the tax authorities, has made a transfer pricing adjustment in accordance with the decision of the tax authorities. Other parties to the transaction can benefit from the rules on corresponding adjustments after they receive the respective notification from the tax authorities.

It should be noted that corresponding adjustments can be made without amendments to the tax ledgers and/or primary documents. The tax base correction can be made in the current period without submitting revised tax returns.

Advance Pricing Agreements (APA)

The Law provides for a new rule under which taxpayers can enter into an APA with the tax authorities. This agreement will regulate the pricing mechanism and the application of transfer pricing methods with respect to a definitive list of controlled transactions during the life time of such an agreement.

This facility will be available only to Russian organisations, including those with pricing issues under cross-border transactions. The amount of stamp duty payable for concluding an APA will be RUB 1.5 million.

An APA can be approved for a maximum period of three years and may be extended for a further two years at the request of the taxpayer.

Under the general rule, an APA enters into force from 1 January of the calendar year following the year in which the agreement is signed. However, the terms of an APA could provide for other timeframes for its application: the Law permits the extension of the application of an APA for the period starting from the date when the taxpayer appealed to the tax authorities to the date when the APA enters into force.

A breach of the APA's conditions can result in accrual of taxes, late interest charges and penalties. However, the sanctions would be imposed only when breach of the APA's conditions led to a tax underpayment.

Tax control with respect to transactions between related parties

The Law introduces a new type of tax control, which is expected to be implemented by a new subdivision of the Federal Tax Service of Russia. A transfer pricing audit should last no longer than six months, but in exceptional cases, it can be extended by up to twelve months.

A transfer pricing audit can be caused by a notification of controlled transactions, which should be submitted annually to the tax authorities, or by information received from a local tax body conducting desk or field tax audits.

Tax authorities cannot conduct more than one tax audit with respect to one transaction (or a group of similar transactions) for one calendar year. In addition, if in the course of a tax audit the tax authorities identify that the terms of a transaction are inconsistent with the terms of transactions with related parties, other parties to the transaction should not be subject to a tax audit.

Transfer pricing audits may cover controlled transactions conducted in the three-year period preceding the year in which the decision to perform the transfer pricing audit is adopted by the tax authorities. The Law provides for shorter deadlines for initiating transfer pricing audits with respect to transactions under which income/expenses were recognised for profits tax purposes in 2012 and 2013. Thus, transfer pricing audits for transactions completed in 2012 can be initiated only until 31 December 2013; for transactions completed in 2013, audits can be initiated until 31 December 2015.

The report on the results of a transfer pricing audit, which contains information with respect to the subject and timeframes of the audit performance, should be issued on the last day of the audit. If in the course of the tax audit the tax authorities reveal certain transfer pricing failures, which lead to an underpayment of taxes, a determination of the tax audit should be prepared within two months from the date when the report is drafted. The tax authorities should deliver the determination to the taxpayer within five days. The taxpayer can provide its objections within a further twenty days. Further analysis of the tax audit documents and issuing the tax audit decision is conducted in the same order as under the 'ordinary' tax audit. It should be noted that additional tax liabilities assessed by the tax authorities as a result of such audit could be imposed only via court litigation.

Penalties for breach of transfer pricing legislation

The Penalties are introduced starting from 2014.

The Law completes the Tax Code with new provisions envisaging responsibility for breaching transfer pricing legislation. In particular, the taxpayer will be obliged to pay a penalty of RUB 5,000 for inaccurate provision or illegal non-provision of notification with respect to controlled transactions.

The penalties imposed with respect to an underpayment of taxes resulting from setting non-market prices (including when APA is concluded) are established at a level of 40% of the amount of tax underpaid, but not less than RUB 30,000. This high penalty rate will be applied from 2017. In 2012 and 2013 no penalty will be applied. In 2014-2016 transfer pricing penalties of 20% of the amount of the additional tax payable will be introduced.

Actions to be undertaken by companies with respect to new transfer pricing legislation

For the purposes of practical implementation of the Law after its coming into force, we recommend that companies undertake the following procedures which could help to control transfer pricing issues arising with respect to controlled transactions:

1. Consider whether the company intends to conduct transactions that could be treated as controlled in the next year.
2. Prepare a list of persons and entities which could be treated as related under the Law.
3. Develop a pricing policy, taking into account the conditions under which transactions could be treated as controlled, and to set out this policy in the internal procedures.
4. Develop a methodology for market price determination (including transfer pricing method selection and provision of a basis for choice) and to establish it in the accounting policy or in the separate internal procedures.
5. Determine comparable transactions criteria in case of the identification of controlled transactions.
6. Determine market price ranges.
7. Determine profitability ratios and profitability ranges.
8. Establish procedures with respect to corresponding transfer pricing adjustments with counterparties.
9. Develop internal procedures for regular transfer pricing controls in accordance with the provisions of the Russian legislation.

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 20 October 2011.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Euro (EUR)	1.00000	1.37873
Canadian dollar (CAD)	0.71568	0.98683
New Zealand dollar (NZD)	0.57730	0.79602
Russian rouble (RUB)	0.02330	0.03212

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