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TRANSFER PRICING NEWS

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INTRODUCTION

Transfer pricing is increasingly influencing significant changes in tax legislation around the world. This 9th issue of BDO's Transfer Pricing Newsletter focuses on recent developments in the field of transfer pricing in Germany, Lithuania, Israel, and India. Our article about transfer pricing in Belarus is of a more general nature, outlining the recently introduced transfer pricing rules.

In this newsletter you will also find an interesting contribution about the recent changes in the Controlled Foreign Companies and 'Patent Box' rules in the United Kingdom, and their importance for transfer pricing.

As there is a constant and increasing demand for transfer pricing engagements to be properly carried out, 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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SEMINAR

BDO will hold a Transfer Pricing Seminar on 21 June 2012 in Brussels.

Stefaan de Baets from the Organisation for Economic Co-operation and Development (OECD), as a key note speaker, will discuss the OECD agenda and observations on the work of working party No. 6 on intangibles. Various aspects of group services and Value Chain Tax Management will also be among the topics discussed.

If you are interested in taking part in the event, please contact your local BDO office for more detailed information.

BELARUS
TRANSFER PRICING

At the end of 2011 Law No. 330-3 of the Republic of Belarus made more than 200 amendments to the Tax Code of the Republic of Belarus, including amendments concerning transfer pricing control. It is worth noting that before these norms were adopted, transfer pricing control had not been developed in the national legal thought, but there was background for its development in law – Article 20 of the Tax Code of the Republic of Belarus provides a definition of related parties.

Individuals and/or entities are recognised as related parties when their relationships directly influence conditions or economic results of their activity or the activity of entities represented by them. The list of related parties includes a number of categories.

Adoption of transfer pricing control legislation in the Republic of Belarus is an integral part of the law harmonisation process within the Customs Union, as transfer pricing rules have already been adopted by the Russian Federation and the Republic of Kazakhstan.

Transfer pricing control is a new form of tax control aimed at preventing tax evasion by means of price manipulation. Thus since 1 January 2012 the tax authorities are entitled to compare the taxable profit in respect of a transaction based on the prices used by the taxpayer with the taxable profit determined considering market prices. Where these prices differ, resulting in tax evasion, the tax authorities are entitled to adjust the taxable profit and recalculate the tax payable.

Current profits tax payments in the tax period following an audited period are not recalculated. Taxpayers can independently adjust their taxable profit prior to the commencement of an inspection by the tax authorities.

The Article specifies the types of transactions under the control of the tax authorities:

- Sale of real estate, if the transaction price is more than 20% below the market price on the date of sale;
- Foreign trade, if the price of the transaction (transactions with one party), within one calendar year, exceeds BYR 20 billion on the date of acquisition or sale of goods, and the price of the transaction differs by more than 20% from the market price for the goods on the date of acquisition or sale;
- Foreign trade with a related party, if the price of the transaction (transactions with one party), within one calendar year, exceeds BYR 20 billion on the date of acquisition or sale of goods, and the price of the transaction differs by more than 20% from the market price for the goods on the date of acquisition or sale.

For these purposes foreign trade includes sales of goods to foreign legal entities and/or individuals (including commission and agency agreements and similar civil law agreements), and acquisitions of goods from foreign legal entities and/or individuals (including commission and agency agreements and similar civil law agreements).

The tax base is determined on the basis of market prices for goods by using one of the following methods:

- Transaction Value of Identical (Similar) Goods Method. This method involves comparing the transaction value with the prices for identical goods (where this is not available, similar goods) within the range of market prices. The range of market prices is two or more market prices determined on the basis of available information on prices in the reviewed period or on the nearest date of the analysed transaction settlement. If the price of the analysed transaction is lower (higher) than the minimum (maximum) value of the market price range, the minimum (maximum) price from the range is used for the tax calculation;
- Resale Price Method. The market price is determined as spread between the resale price and resale costs (regardless of the acquisition price) and market promotion of the goods as well as ordinary income of the purchaser from the goods' subsequent resale;
- Cost Plus Method. The market price for the goods sold by the taxpayer is determined as a sum of incurred costs and ordinary income for this activity (profitability). Ordinary costs for this activity, including production (acquisition) costs and/or sale costs, transportation costs, insurance expenses, storage costs and others are taken into consideration.

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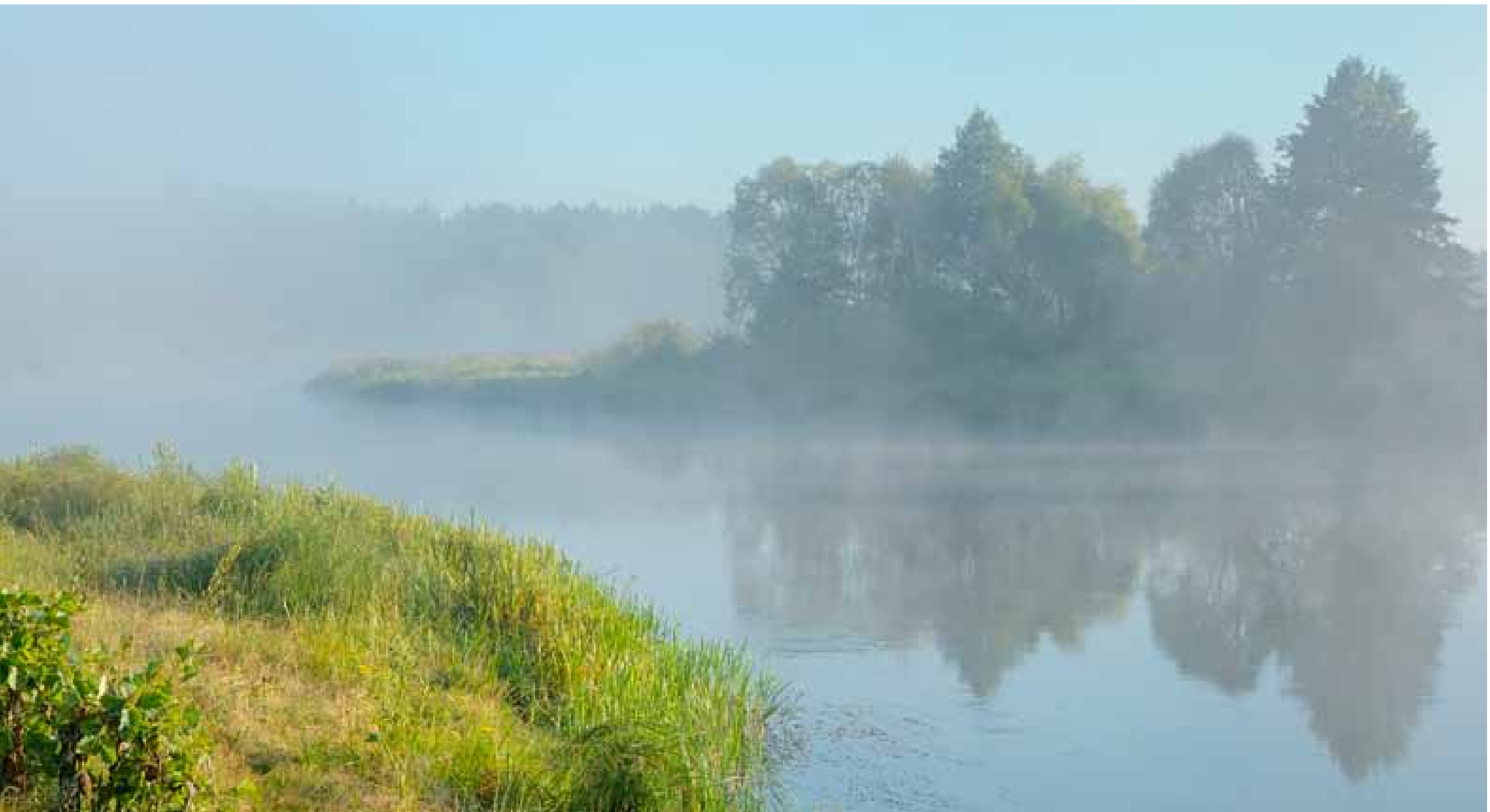

GERMANY

PROPOSED CHANGES TO GERMAN TRANSFER PRICING LAW

The German Ministry of Finance has published a draft bill for tax law changes which will become effective on 1 January 2013. The draft is subject to discussion and revision by the Parliament and the Federal Council of Germany. The following comments focus on the most important envisaged changes in the area of Transfer Pricing.

The law aims at applying the arm's length principle to all types of cross-border transactions irrespective of whether the transactions take place between corporations and/or partnerships and/or permanent establishments. Firstly, the law clarifies that the arm's length principle also applies to partnerships. From a legal perspective, a German limited or unlimited partnership may conclude agreements with other entities. However, the income of a partnership for corporate or individual tax purposes is attributed to the limited or unlimited partner, and taxed at the level of the partners. Therefore, the law now clarifies that the arm's length principle directly applies to the business transactions between the partnership and other entities or permanent establishments. In this regard the legislation will also cover partnerships which do not carry on a trade of business but limit their transactions exclusively to the administration and use of their assets (for instance, renting out real estate).

Furthermore, the amended legislation will replace the term 'business relation' (*Geschäftsbeziehung*) by the term 'economic transaction' (*wirtschaftlicher Vorgang*), in order to clarify that all legal contractual relationships as well as other transactions will be considered. In this regard, the law will include a rebuttable presumption that all business transactions, with or without evidence for contractual agreement, will be treated as if such agreements were available. In addition, economic transactions ("dealings") between entities and foreign permanent establishments are regarded as economic transactions.

In this regard, the law will explicitly state that cross-border business transactions between entities and their permanent establishments (including branches) are subject to the application of the arm's length principle. Thus, the law wants to consider the new "Authorised OECD Approach", which has been introduced by the revised OECD Transfer Pricing Guidelines in July 2010 and which treats permanent establishments as if they were independent enterprises. Hence, despite the fact that no contractual relationship is possible between an entity and its permanent establishment (in practice frequently so-called "pro-forma agreements" are made for purpose of evidence), the arm's length principle has to be applied to transactions between head office and permanent establishment. This means that for the allocation of profits the permanent establishment is treated as an independent enterprise, unless international taxation principles require a different treatment (for instance, limited application for debt financing). In line with the new authorised OECD approach, the allocation of profits to a permanent establishment will be made in two steps, and should in the first instance consider the people functions. These functions determine which assets, functions and risks have to be attributed to the permanent establishment. In a second step, the dealings between head office and permanent establishment then need to be considered. The application of the usual transfer pricing methods results in the attribution of taxable profits to the permanent establishment.

The fiction of an independent enterprise may achieve the result that a permanent establishment can generate a profit although the enterprise as a whole suffers a loss, or the permanent establishment suffers a loss despite the fact that the whole enterprise generates a profit.

Partnerships and permanent establishments in Germany are subject to compulsory transfer pricing documentation in line with the rules that are applicable for corporations. This also means that the relief for small businesses may be claimed.

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INDIA

BUDGET PROPOSALS FOR FINANCIAL YEAR 2012-13

On 16 March 2012, the Union Finance Minister of India announced the various tax proposals in connection with the union budget in Parliament. There were some quite significant changes to international taxation, including transfer pricing. We discuss below the various proposals with implications for transfer pricing.

Advance Price Agreements

The budget introduced Advance Price Agreements (APA), inserting sections 92CC and 92CD under the Income Tax Act, which will take effect from 1 July 2012. APA will allow the taxpayer to enter into an agreement with the tax authority on the arm's length price that will be transacted between two associated enterprises, bearing in mind the regulations in place.

Transfer pricing was introduced in India in April 2001, but without any APA facility, in contrast to most other countries which have transfer pricing rules which do allow APAs.

The salient features are:

1. The agreement is binding on both the tax authority and the taxpayer.
2. The maximum duration for an agreement is five years.
3. The method of determining the arm's length price is based on the existing methods or any other method.
4. Central Government can declare an agreement as void ab initio in certain circumstances.
5. After entering into an agreement the taxpayer can file a modified return within a period of three months.
6. Assessments or reassessments will be made according to the agreement and within the revised time limit as specified.

Currently, until the detailed rules are announced, the various time limits for concluding and filing an APA (which will be crucial) are not known. The nature of the details which will need to be provided to the tax authority is also unclear.

Implications: The introduction of APA will provide certainty for taxpayers on tax issues in relation to international transactions with associated enterprises. In particular, the current level of litigation on transfer pricing matters is quite alarming and highly inefficient due to the high time and administrative burdens for taxpayers, so this is expected to be an effective tool to reduce transfer pricing litigation.

Non-reporting of international transaction

In India currently all international transactions with associated enterprises must be reported in the specified form (form 3CEB), duly signed by the accountant, to be filed along with the tax return. The tax authority will only scrutinise the transactions which are reported.

However, a retrospective amendment has been made with effect from 1 June 2002, whereby the transfer pricing officer (TPO) has been empowered to compute the arm's length price of a transaction which comes to their notice during the course of proceedings, even if such transactions have not been reported/referred by the Assessing Officer, including transactions not reflected in form 3CEB. The TPO might therefore go beyond the form of the transaction and will look further.

The above amendment was introduced in last year's budget by inserting sub section 2A of section 92CA. However in the current proposal, a corresponding amendment has also been made under section 147, whereby such unreported transactions can be regarded as "having escaped assessment", and hence past years' transactions can potentially be reopened. However, although the current proposal is retrospective, the government will not reopen old cases which have been finalised, but has the power to do so in future. Finally, a corresponding amendment has been made to the penalty provisions under section 271AA, whereby a penalty can be levied at 2% of the transaction value.

Implications: some transactions cannot be reflected in the accounts, but the conduct of associated enterprises may lead to the creation of intangibles. Such transactions need to be evaluated during the course of documentation.

Arm's length range

The range, defined under section 92C, has been lowered from the current rate of 5% to 3%.

The method of calculating the range has created much controversy in the past few years, and accordingly an amendment was made with effect from 1 October 2009 to clarify the intent of the law. Essentially, it means that whenever a transaction is outside the range, the calculation of the adjustment will not be from the extreme end of the range; rather, it will be from the mean of the arm's length price. In the past, even the tax tribunals have often ruled that it should be treated as a standard deduction, meaning that the calculation of the adjustment will be from the extreme end of the range, due to the wording of the section.

The current amendment is retrospective, with effect from 2002, clarifying the same position as amended earlier.

Implications: in consequence of the narrowing of the range, it will be very important to select the right size of comparables.

Clarifying the definition of international transaction

The amended definition is broad-based, exhaustive and clarificatory in nature. The current definition includes a detailed list of intangibles. Hence, it is important for the taxpayer to identify this when preparing transfer pricing documentation/certification so that it can be reported properly in form 3CEB, to avoid a non-reporting penalty (as discussed above).

The other main proposed change is to include in the definition any business restructuring or reorganisation transaction between associated enterprises. Such transactions need to be reported in the form 3CEB, whether or not they have any bearing in the profit/loss of the company in the current year.

This amendment is again retrospective from April 2002.

Implications: the implications are the same as for those for the non-reporting of transactions.

Specified domestic transactions covered under the transfer pricing regime

For the first time in India, domestic transactions must also comply with transfer pricing rules in a similar way as that of international transactions.

Currently in the domestic law in India, there are certain sections under which transactions between two related parties must be based on market value. With the proposed change in the law, those transactions must be at arm's length, based on the methods as defined. Hence, there is a shift from the market value concept to a method based application in order to prove it as arm's length.

In the existing law, sections 40A, 80A and 80IA refer to transactions which must be based on market value. These transactions will now be covered under the transfer pricing rules. However, a threshold of INR 50 million, based on the value of the transaction, has been prescribed for this purpose.

Dispute Resolution Panel (DRP)

1. The DRP was put in place three years ago, with a primary objective of (a) reducing the time required for appealing at a tax tribunal and (b) reducing the amount of litigation. Accordingly, the government fixed a time limit of nine months for the DRP to make a direction to the assessing officer, and the tax authority cannot appeal against the direction issued by DRP at a tax tribunal.

   However, in the proposed change the tax authority can file an appeal against the direction of the DRP at a tax tribunal, so the number of disputes will increase many-fold, defeating the basic purpose of establishing the DRP.

2. Power of the DRP: where the tax authority proposes to make an adjustment, it will issue a draft order to the taxpayer, with the reason for the proposed adjustment. The tax payer can file an application against such an order before the DRP. The application would include the reasons and arguments against the draft order. Hence, it was considered that the DRP has only a limited power to decide on the matter referred to in the draft order.

   However, it has been clarified that the DRP can go beyond the issues raised in the draft order. This means that the DRP can now raise any issue during the proceedings, even if this has been raised by the tax authority earlier and a satisfactory response given.

This amendment applies to assessment year 2009-10 and subsequent years.

However, it must be emphasised that the above proposals/amendments are subject to approval in parliament and subsequently the assent of the President of India, which is expected to happen in July 2012, but will be effective from 1 April 2012.

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ISRAEL

ISRAELI TRANSFER PRICING AUTHORITY INTENDS TO INCREASE ENFORCEMENT OF FINANCIAL TRANSFER PRICING TRANSACTIONS

Senior officials from the Israeli Tax Authority have recently voiced their intention to step up enforcement of transfer pricing transactions. An increasingly common type of transfer pricing transaction that is likely to draw increased scrutiny are financial transfer pricing transactions by multinationals in the real estate industry.

In accordance with Section 85A of the Israeli Tax Ordinance, Israeli companies are required to complete corporate form 1385 along with the corporate tax return. This requires taxpayers to declare that inter-company transactions were carried out at arm's length terms. The declaration to be made on corporate form 1385 also extends to inter-company financial transactions, including various types of loans, such as fixed-term loans and credit facilities.

The following section outlines several points to consider for international legal entities with operations in Israel and abroad, while a special emphasis should be placed on companies engaging in real estate activities. (International tax issues should be examined separately and are outside the scope of this article).

As mentioned, financial transactions are one of the more common types of inter-company transactions that are carried out by international real estate companies. Consider the following scenario of an Israeli international real estate company:

An Israeli real estate company ("IsCo") is interested in establishing an income-yielding property in a foreign European country ("AbroadLand"). IsCo establishes a subsidiary company in AbroadLand, ("SubCo"), which purchases the land on which the property will be built. In order to finance the land purchase and property development, IsCo provides SubCo with an inter-company loan (while there may be other financing options available, for the purpose of this article, an inter-company loan has been selected as the source of financing). IsCo charges interest on the inter-company loan provided to SubCo.

In accordance with transfer pricing legislation in AbroadLand's tax regime as it relates to financial transactions (e.g. interest on inter-company loans), if the interest rate charged by IsCo was to be above arm's length terms, it is reasonable to assume that AbroadLand's tax authorities would likely challenge, or at least further scrutinize, the interest rate being charged. The end result may be that a portion of the interest payment will not be recognised as a deductible expense. From an Israeli perspective, a double taxation situation may be created, as IsCo would pay taxes on recorded income or notional income resulting from the interest payments that may not be deductible by the SubCo. In an effort to prevent this situation from occurring, it is crucial to properly price the arm's length interest rates on inter-company loans, both from a domestic and foreign perspective. Referring to the example described previously, it should be noted that some existing tax treaties do address double taxation issues (e.g. interest expenses/taxes paid on income). However, resolving double taxation issues via tax treaties (with the tax authorities) is liable to be a time-consuming and expensive process with uncertain results.

Another example that should be carefully examined are back-to-back loans, where for example an Israeli parent may receive a loan from a third party bank at a certain interest rate due to, inter alia, its good credit rating, and then "passes on" the loan amount to its foreign subsidiary. In this example, the profitability from the loan provided by the Israeli parent should be carefully examined, as the Israeli tax authorities are likely to expect an arm's length interest payment from the foreign subsidiary that received the loan. In addition, it should be noted that certain jurisdictions have issued guidance on back-to-back loans, and this should also be taken into account when determining inter-company interest rates.

Another point to be considered when trying to determine the subsidiary's credit rating is the influence of the parent company's credit rating on the subsidiary that received the loan. The question arises as to whether or not the parent company's credit rating should also be taken into account and if so, to what extent.

The following examples are additional issues, inter alia, that may draw the attention of the Israeli tax authorities in the near future (as is the practice of certain foreign tax authorities).

1. Determining a synthetic credit rating – determining a synthetic credit rating for the company receiving the loan may be an area of contention, and should take into account all relevant factors (e.g. guarantees, seniority of debt, etc.).
2. Thin capitalization – if the debt to equity ratio of the company receiving the loan exceeds a certain ratio, this may be scrutinised by the tax authorities, and interest payments exceeding certain ratio thresholds may be non-deductible.

Due to a recent amendment in the Israeli tax regulations, in some instances the Israeli transfer pricing legislation is not applicable to certain types of loan. Such loans may provide a potential solution to overcoming the challenges of providing inter-company financing.

The conditions include, inter alia, the following:

– The loan should bear no interest;
– The loan should not be repaid for a minimum period of 5 years; and
– The repayment should be subordinate to other liabilities and precede only dividend distributions upon liquidation.

It is important to note that while this type of loan may be exempt from transfer pricing requirements from an Israeli perspective, it may very well be challenged by foreign tax authorities.

To summarise, in order to navigate the murky waters of inter-company financial transactions that have become exceedingly commonplace in today's dynamic business environment, it is highly recommended that multinationals operating in or from Israel should firstly consult a qualified professional.

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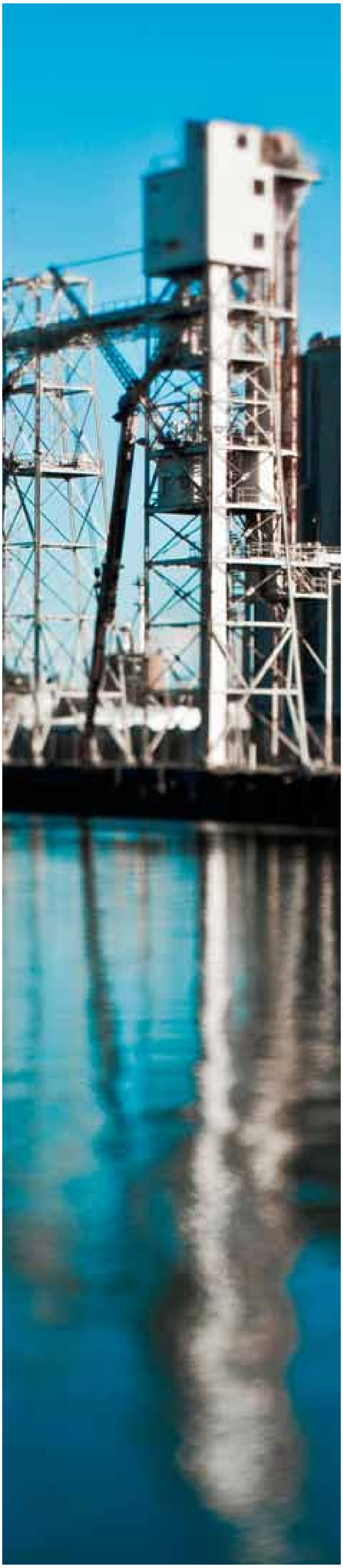

LITHUANIA

ADVANCE PRICING AGREEMENTS IN LITHUANIA

From 2012 Lithuanian companies will be able to agree advance controlled pricing arrangements with the tax administrator. This should provide clarity and certainty for international companies, in particular those planning to carry out large-scale transactions with associated companies.

The amendment to the Tax Administration Law which enables taxpayers to apply for advance transfer pricing agreements with the tax administrator applies from 1 January 2012. Agreements between taxpayers and the tax administrator on transfer pricing methodologies and assessment principles can therefore be made from that date.

The transfer pricing agreements may be used for various intergroup transactions, and will be binding for a specific period, i.e. they will be valid for the current year and for five years from the date of the tax administrator's decision. After the expiry of this period the agreement can be extended if the circumstances of the controlled transactions have not changed. These agreements are issued only for **future transactions**, unlike the position in some Western European countries, where pricing agreements are also issued for past transactions, to ensure fiscal transparency in case of possible inspections.

After receiving the pricing agreement from the State Tax Inspectorate, the taxpayer can choose not to follow it. In addition, the tax administrator also has the right not to follow the agreement during an inspection if the actual circumstances of a transaction differ from those set out by the taxpayer in the application. An agreement will expire if there is a change in legislation, or if new Lithuanian or EU legal decisions that affect the agreement are published.

A pricing agreement will benefit the taxpayer by ensuring the clarity of tax issues in relation to future intergroup transactions, reducing the fiscal risks associated with such transactions.

Despite their significant advantages, pricing agreements do have some disadvantages, the greatest of which is that the taxpayer must provide a considerable amount of complex and revealing documentation when applying for an agreement. In the application, the taxpayer must accurately and unambiguously describe the future transactions, the circumstances to which the tax legislation will apply, the relevant provisions of the legislation, and other information and evidence on which the application is based. The term “future transaction” means a transaction or economic operation which the taxpayer or any group company will commence to carry out after the date of the application to the tax administrator. The application cannot specify a tax rate. As taxpayers must consider all aspects of transactions in advance in order to reach an agreement, this should help to avoid the situation encountered in practice, when attempts are made to justify arrangements retrospectively, in the absence of proper transfer pricing planning.

The tax administrator must give a ruling on an application within 60 days of receiving it, but an additional 30 days is allowed for the examination of applications received up to 1 July 2013. A further 60 day extension can be granted if additional research is required to process an application. Processing time extensions must be notified in writing to the taxpayer making the application.

The clarity brought by pricing agreements significantly contributes to the improvement of the Lithuanian tax regime, making it easier to attract foreign investors.

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UNITED KINGDOM

TRANSFER PRICING AND CONTROLLED FOREIGN COMPANIES

Transfer pricing becomes central to the operation of the UK's new Controlled Foreign Companies (CFC) and Patent Box rules. Statistics from HMRC on UK transfer pricing enquiries. Pragmatism from a tax authority on transfer pricing – Whatever next?!

Background

2012 heralds some significant changes to the UK tax environment for corporates. Two particular such points – the new CFC rules and the proposed Patent Box regime – have clearly already had an impact on investment decisions by a number of groups. The announcements by WPP (that they are likely to re-domicile back to the UK) and by GlaxoSmithKline (that they are to invest more than GBP 500 million in manufacturing in the UK, creating up to 1,000 new jobs) are evidence that the UK is attracting large scale investment as a result of its tax policies. Transfer pricing plays a critical (if not central) role in the application of these new rules.

HMRC has also recently provided insight into both the UK's tax yield from transfer pricing enquiries and other measures of HMRC performance in dealing with transfer pricing issues. In addition, HMRC has set out how it is investing in 'real time working' to reduce the incidence of taxpayer controversy and give greater certainty to business.

The relevance of transfer pricing to the new CFC and Patent Box regimes

Transfer pricing principles are critical to both the application of the new CFC rules and the Patent Box (the latter of which is examined elsewhere in this edition).

The new CFC regime potentially requires the consideration of 'Significant People Functions' - a concept drawn from transfer pricing principles applied in the OECD Report on the Attribution of Profits to Permanent Establishments - as a means of measuring the extent to which there is a 'significant mismatch between key business activities undertaken in the UK and the profits arising from those activities which are allocated outside the UK' in identifying circumstances where there has been an 'artificial diversion of UK profits' to which an attribution under the CFC rules might apply.

HMRC update on transfer pricing enquires

HMRC has released statistics on the transfer pricing yield and the time taken to resolve transfer pricing enquiries. As shown in the table opposite, transfer pricing appears to be one of the most lucrative means of raising additional corporation tax from large businesses.

The focus of HMRC has historically been on the largest and most complex businesses, given that there was inadequate resource available to deal with transfer pricing enquiries more broadly.

Over the past five years, HMRC has invested heavily in training transfer pricing specialists. This, and more clearly targeted governance for the pursuit of transfer pricing enquiries, has allowed HMRC to more successfully target what it regards as 'high risk' transactions in groups of all sizes, using dedicated transfer pricing support nationally. This investment has resulted in a 650% rise in tax yield from businesses over four years. We expect this trend to continue.

The average time taken to resolve a transfer pricing enquiry in 2011 was 24.4 months.

How about other tax authorities?

Multinational businesses now face transfer pricing legislation in most jurisdictions. Whilst many other tax authorities incorporate the OECD Transfer Pricing Guidelines in their local law, each tax authority will have their own subjective interpretations of the rules in terms of preferences for different methodologies and on economic substance versus legal form.

In terms of pragmatism in dealing with taxpayers on transfer pricing issues, however, it seems that HMRC are highly rated by corporates. 98% of corporates surveyed at a recent leading transfer pricing conference felt that other tax authorities were more difficult than HMRC to deal with on transfer pricing matters. The US, India, Germany, Italy and Brazil were cited as being countries where significant transfer pricing challenges are likely to arise, which goes to show how important it is to get both global and local transfer pricing advice.

What are the implications of HMRC's developing approach for businesses?

There are still a sizeable number of groups that do not have adequate transfer pricing documentation in place. The statistics above highlight that this position is unlikely to remain tenable from an internal risk perspective.

Where there has been inadequate support for a transfer pricing policy, we have seen HMRC enforce transfer pricing adjustments over multiple years, with potential penalties of up to 100% of the adjustment. Given this risk, we are routinely seeing auditors requesting copies of transfer pricing reports before issuing a clean opinion.

So the first step is to make sure all group policies can be supported and documented from both UK and overseas transfer pricing perspectives in order to minimise transfer pricing risks.

Year	2007/8	2008/9	2009/10	2010/11	2011/12
Total*	519	1,595	1,039	436	1,000 current estimate
Large Business Service*	494	1,564	973	273	No data
Local Compliance*	25	31	66	163	No data

* GBP million

HMRC's investment in certainty for businesses

HMRC realises that transfer pricing is a large cost to business in terms of resource and potential double taxation. It is moving resource into real time working with businesses to give better certainty.

HMRC is offering the opportunity for businesses to talk through their transfer pricing documentation with their Inspector.

HMRC has made it clear that it is happy to provide guidance to businesses on their prepared documentation and the methodologies that they have used. This can allow businesses to informally agree or adjust their position to take into account HMRC's comments. This informal approach provides a quick and relatively inexpensive means of lowering a group's UK transfer pricing audit risks, with consequent financial and resource savings.

Certainty internationally

Having a discussion with an Inspector can lower UK transfer pricing risk. It can also lower overseas transfer pricing risks, where HMRC agrees to support a position in the event of a dispute with an overseas tax authority. However, it does not provide any legally binding agreement on HMRC or absolute certainty on overseas matters.

HMRC has had an Advanced Pricing Agreement (APA) programme for many years that provides for bilateral agreement on transfer pricing matters between different tax authorities. In 2010, HMRC updated its guidance on APAs to allow businesses to join the programme, regardless of size, provided the transfer pricing issue is sufficiently complex. The number of APA applications has increased by 53% in a year from 2010 to 2011 based on these changes.

Where a group has major transaction flows with related parties cross-border where there is prospective transfer pricing risk, an APA can provide certainty for a number of years, eliminating potential double taxation and allowing transfer pricing provisions in the accounts to be released. It could also act as support for transfer pricing enquiry defence in other territories.

An APA tends to work best with businesses with a relatively stable business model, as they will take on average 20-22 months to be concluded and require an investment in internal resource and professional advisory fees.

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TRANSFER PRICING AND THE PROPOSED PATENT BOX REGIME

The UK's proposed Patent Box regime will apply an effective 10% rate of corporation tax to profits derived from patents with effect from 1 April 2013. Advanced planning may assist in maximising profits which may fall within the new regime.

This is part of the Government's drive to provide an additional incentive for businesses to retain and commercialise existing patents and develop new innovative patented products in the UK.

The relevance of transfer pricing to the new Patent Box regime

Transfer pricing principles are critical to the application of the Patent Box rules.

The Patent Box regime utilises transfer pricing concepts to allocate income to the Patent Box. HMRC expects the Patent Box to lead to a detailed focus on transfer pricing, given its critical role in the allocated part of income between that subject to the full corporate rate and that subject to the effective 10% Patent Box rate.

Companies eligible for the Patent Box

A company can elect into the Patent Box regime if it owns or has a licence over patents granted by the UK Intellectual Property Office, European Patent Office or patent offices in certain EU member states. The profits qualifying for the Patent Box regime are those deriving from the item protected by the patent and can also apply to **profits derived from any product incorporating the patent item** (no matter how insignificant the cost of the patented item in relation to the total cost of the product incorporating it). The calculation of the tax basis for those profits qualifying for the regime also means that certain other non-patented technical intellectual property may benefit from the 10% effective tax rate.

Rate of tax

Relief is given through an additional deduction in the company's corporation tax computation, the effect of which is to reduce the rate of tax on relevant Patent Box profits to 10%. The relief is optional.

Worldwide profits

Worldwide profits from these patents (not just those generated in the UK or EU) will be included.

Qualifying conditions

There are two principal qualifying conditions:

- First, the company must have made a significant contribution to the creation or development of the item protected by the patent or a product incorporating this item. In a group situation, provided the company holding the patent in the year of claim actively manages its portfolio of qualifying rights, another group company can undertake (or have undertaken) the qualifying development (even if this is – or were – outside of the UK).
- Secondly, if the claimant company licences in patent rights it must have exclusivity which is at least country-wide.

The conditions mean that, say, a non-UK company which actively manages an item protected by a patent (or incorporating it) can still qualify for the Patent Box if the patent or licence to it has been created or developed by a non-UK group company and subsequently transferred to it.

Calculation of Patent Box profits

The calculation of Patent Box profits will generally be based on formulae which, once established, can be used in successive periods. Opportunities exist for a more bespoke calculation if this is beneficial. Details of the calculation are shown below.

Patent pending period

There may be a number of years between application for a patent and its grant. Relief will be claimed in the accounting period of grant by recognising, at that point, qualifying income and profits in the period from application to grant (subject to a maximum period of 6 years).

Commencement of the Patent Box regime

The proposed commencement date for the new regime is 1 April 2013.

The full benefit of the regime will be phased in over five years from 1 April 2013 by applying a percentage to the relevant IP profits on a sliding scale, with 60% of such profits included in FY 2013, 70% in FY 2014, 80% in FY 2015 and 90% in FY 2016.

Detailed calculations

Stage 1 – Calculate Relevant Intellectual Property Income

This is income from sales of the patented item or an item incorporating it, licence fees and royalties, patent disposals and infringement compensation.

Profits from the sale of products made via a patented process (where the products are not themselves covered by a patent) are also included in the Patent Box regime. Companies may calculate a notional arm's length royalty for the use of the patent and include this notional income in the calculation.

Stage 2 – Allocation of profits

Profits are allocated to the Relevant IP Income and other income on a pro-rata basis or through a 'just and reasonable' apportionment of expenses (it would seem sensible to do so based on transfer pricing principles).

Stage 3 – Remove the routine return

It is assumed that, in the absence of unique IP and other intangible assets, a routine return of 10% would still be achieved on that company's personnel, premises, plant and machinery and miscellaneous expenses. This routine return is eliminated from the pool of patent profits (with an alternative approach available for smaller claims) leaving 'Qualifying Residual Profit'. However, the cost base of the company to which the 10% mark up applies excludes costs of other group companies providing services to the Patent Box company and, therefore, the basis on which that mark up applies will depend on the nature of the group's operational structure.

Stage 4 – Remove the marketing return

The residual profit is then subject to a final adjustment to eliminate the return achieved on marketing assets (including know how, trademarks, and company names and logos) by deducting a notional marketing royalty. This is intended to exclude from the regime the substantial profits which can be generated using established brands.

For small claims this adjustment is calculated on a formula basis. For larger claims a notional marketing royalty must be calculated (using transfer pricing principles) and deducted from the residual profit.

How we can help

We can assist in planning for the new Patent Box regime, including:

- Helping to identify qualifying IP and revenue streams;
- Discussing the merits of electing into the regime;
- Establishing where qualifying patents should be held;
- Analysing the different bases for calculation and planning opportunities to maximise the claim;
- Developing transfer pricing methodologies and tools for data collection for computing income and expenses at the various stages;
- Assisting with compliance obligations.

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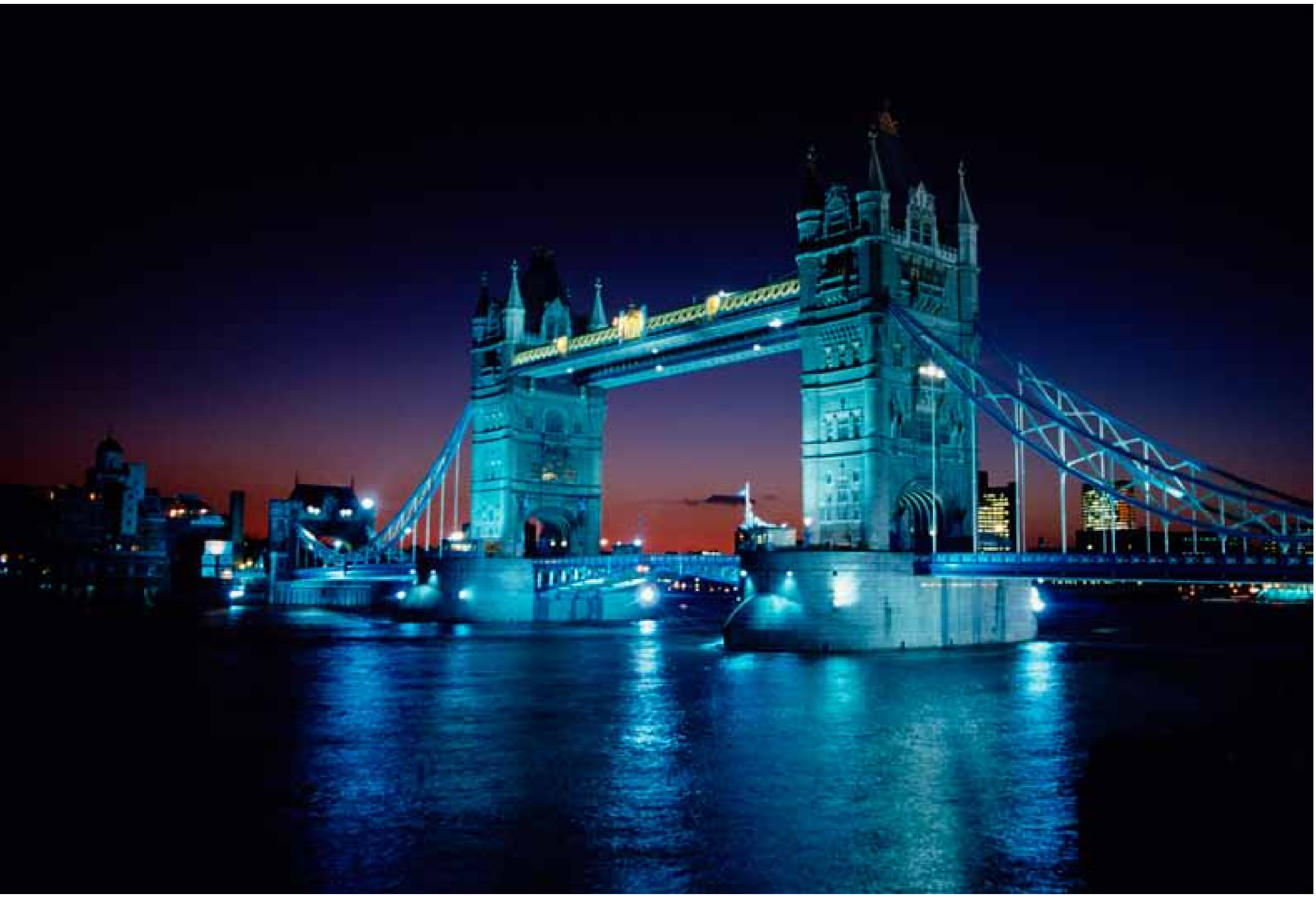

CURRENCY COMPARISON TABLE

The table below shows comparative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 1 June 2012.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Belarusian Ruble (BYR)	0.00010	0.00012
British Pound (GBP)	1.24892	1.54644
Indian Rupee (INR)	0.01425	0.01765

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